A Letter from the Chairman

Fiscal year 1998 proved to be another successful year for the United States Postal Service. We saw continued improvement in our overnight service performance and a radical improvement in our two- and three-day service. This was accomplished without negatively impacting our financial performance, where, for an unprecedented fourth straight year, we had a positive net income that goes directly to the bottom line to reduce our negative equity, which had accumulated in prior years.

This was also a critical year for the Board of Governors of the Postal Service in our oversight of postal activities. These responsibilities include directing and controlling expenditures of the Postal Service, reviewing its practices, participating in long-range planning, and setting policy on all postal matters. Many of these activities are coordinated through four committees of the Board: Audit, Capital Projects, Compensation, and Strategic Planning. While these committees do not have approval authority, they provide a vital link between postal operations and the Board on activities reserved for Board approval.

During 1998, we were called on to exercise two of our most important functions as Governors. In May, former Postmaster General Marvin Runyon returned to private life after nearly six years as Postmaster General/CEO of the Postal Service. After a thorough search and consideration of both internal and external candidates, the Governors selected Chief Operating Officer William J. Henderson as the 71st Postmaster General, the first career employee in over 13 years to lead the organization.

In July of 1997, the Postal Service filed a rate case (R97-1) with the Postal Rate Commission, which was returned by the Commission in May 1998 and considered by the Governors at the July 1998 Board meeting. With just some minor exceptions, which were remanded back to the Commission for further consideration, the Governors accepted the Recommended Decision of the Commission. The remanded items were subsequently returned by the Commission and approved as well. The Board set January 10, 1999, for implementation of these rates. This was done after careful consideration of customer and congressional input, management's financial forecasts, and what we believed to be in the best interests of our customers and the Postal Service.

From the beginning, in July of 1997, this rate case was about maintaining a strong universal mail service. The rate adjustment was designed to provide a continuing investment in America's communications future. We saw the need to continue to invest in automation and other infrastructure improvements to keep the Postal Service efficient and to hold down rates in the future and improve the consistency in home delivery. In 1998, the Board approved a capital budget plan of nearly $5.6 billion.

This past year we also saw the results of a Board-initiated study of diversity in the Postal Service. The independent study conducted by Aguirre International identified opportunities for the Postal Service to improve its Diversity Program in the recruitment, training, and promotion of minorities and females, as well as supplier diversity initiatives. Management, at the request of the Board, has established a reporting framework to keep members apprised of progress made in the implementation of recommendations resulting from the study. The fair and equitable treatment of all employees is a high priority of the Board members, and the study brought into focus areas where improvement was needed.

As we move into the new year, we are mindful of the ongoing labor negotiations with our unions, the upcoming consultative process with our management associations, and pending legislation in Congress which could impact the way we do business in the future. We are confident the results of all these efforts will be in the best interest of our customers, our employees, and the United States Postal Service. We have confidence in the leadership skills of Postmaster General Bill Henderson and his management team, and we will continue to provide the necessary support, in our oversight role, to ensure a strong and united Postal Service into the new millennium.

Sam Winters
Chairman
Board of Governors

UNITED STATES POSTAL SERVICE

Financial Section Contents

Financial Q&A with the CFO

M. Richard Porras, the Chief Financial Officer and Senior Vice President, answers some frequently asked questions about the Postal Service.

"The Postal Service continues to build its financial strength. During 1998, we declared a dividend equivalent to $800 million to the American public, by delaying our approved general price increase. We were able to do this because our institution's culture is changing to put an emphasis on using financial information to make decisions. Watching the bottom line is as important to us as serving you, our customers."

M. Richard Porras
Chief Financial Officer
and Senior Vice President

If the Postal Service is making money, why does it need a rate increase?

Like any business, inflation drives our costs, and so does delivering mail to almost 1 million new addresses each year, not to mention the cost of processing the almost 20 billion additional pieces of mail since our last rate increase. Add that all up and you can see that we need additional revenue to cover these increased costs. While we are constantly improving our efficiency to help keep costs down, we simply cannot cover all of these additional costs without some increase in our rates. But our rate increase is only one cent, just one penny. The last time rates increased only one cent was in 1968 when the price of a First-Class stamp went from 5 to 6 cents. Not only is this the smallest percentage increase ever, but it's also less than the rate of inflation.

If the Postal Service needs more money, why doesn't it just get more from the federal government?

Because the Postal Service isn't funded by government appropriations. Our revenues come from selling our services to customers. More importantly, we haven't received any operating subsidies since 1982. Since then, we've been self-supporting, and we haven't received one penny from the American taxpayer.

Why doesn't the Postal Service's net income increase every year like the income of most companies?

Unlike most companies, we can't just raise our prices as our costs increase. Our Board of Governors has to ask an independent body—the Postal Rate Commission—to review and recommend any increase in postal rates. Only then can the Governors act on their recommendation. This entire process—from the time we begin our rate increase request until the time the increase goes into effect—can take 16 to 18 months from start to finish. And during this time our costs for things like fuel, rent, utilities, salaries and benefits keep going up, over 19 percent since our last rate increase in 1995. So our net income decreases each year until we can bring our prices more in line with our costs.

Why does the Postal Service, a government agency, have a profit?

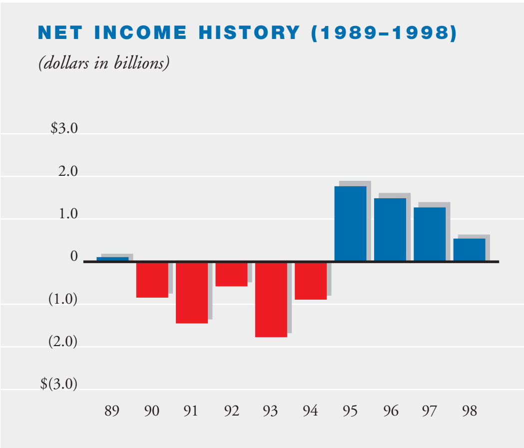
There are important reasons that explain why a government agency such as the Postal Service may need a profit or surplus just like a private business. Like a business, we need funds to make investments in new equipment and technology that allow us to make service improvements that improve customer satisfaction, upgrade our infrastructure allowing us to reduce costs, and meet the needs of a growing American population.

Since we are self-supporting, these funds (cash) must come from our operating activities, or we must borrow money. Historically, we borrowed money based on our capital plans for improvements to property and equipment. Under this policy, our debt reached almost $10 billion. This led to higher interest payments and higher rates. Through negotiations with the U.S. Treasury's Federal Financing Bank, we were able to establish short-term lines of credit. This enabled us to minimize cash and reduce our debt. Since 1994 we have reduced our debt to $6.4 billion. This is one of the reasons our upcoming rate increase is the lowest percentage increase in our history.

Profits, which are a component of cash from operating activities, are a necessary part of prudent cash management that allow us to make the investments we need to operate as efficiently as possible while delivering the kind of service and prices our customers want. In addition, the Board has directed us to restore our equity which was reduced by prior years' losses. These losses accumulated to almost $9 billion between 1971 and 1994. To date we have reduced our prior year losses to under $4 billion.

How does Economic Value Added (EVA) help the Postal Service deliver the mail?

Employees must have a reason to open their minds to change. It can be the threat of competition, reregulation, or a dramatic shift in the way they are compensated, such as bonuses. We think our EVA program is the correct way to implement change. It is considered a best business practice in the boardrooms of many major companies, such as Coca-Cola and General Electric. Our EVA program, which funds our group incentive program for management and nonbargaining employees, focuses on actual results, tying their pay to their job performance and rewarding the most efficient and productive employees. In the three years we have had our EVA program, we have seen dramatic changes in employee behavior. This program



encourages employees to work better, more efficiently, and more creatively. It creates a sense of ownership in employees so we all manage our business more efficiently, control costs, and serve our customers better by developing the products and services they want. With EVA, we can invest efficiently and effectively in the equipment and facilities that our employees need to deliver the service our customers expect.

How will the Five-Year Strategic Plan help the Postal Service comply with the new Government Performance and Results Act?

The strategic plan maps our future. It commits us to achieving excellence in customer service, practicing aggressive cost management and creating unique customer value. It defines our mission, outlines a set of goals, describes the strategies we will use to achieve those goals, and establishes the measures for how well we achieve our goals. The core of the Plan is to ensure that the Postal Service continues to deliver reliable, secure, prompt, and cost-effective service. With the Plan, we will be able to fulfill our commitment to provide the same service at the lowest possible price to all our customers, from individuals to international corporations, no matter where they're located, from the most remote outpost in Alaska to the crowded streets of the largest cities. We don't serve just the select few who can afford our services; we serve everyone everywhere at the same price. That's what we mean by universal service.

Why does the Postal Service plan for equity restoration each year?

Equity is the value of all a company's assets minus all its liabilities. Normally, companies should, at a minimum, have sufficient revenues to cover their costs and to maintain their equity. But for 23 years, from 1971 to 1994, the Postal Service took in less than was required, building up a deficit that totaled $9 billion, and equity seriously declined. Equity is an important representation of a company's financial health; negative equity tells you that all is not well with a company's financial condition. We're working to restore our equity by reducing expenses, raising revenues, managing our cash flow, and increasing our investments to ensure future income. We are now on the road to financial health. Since 1995, we've been restoring equity by setting our rates to include a modest surplus at a rate determined by the Board of Governors. Beginning with the 1995 rate increase, our "break even" point each year includes the money we need to restore equity over about a ten-year period.

What role does diversity play in the Postal Service's financial operations?

We embrace diversity, not just because it's the right thing to do but because it's also plain good business. For example, the Hispanic community is the fastest growing segment of the population, so we need to make an aggressive effort to serve this approximately $250 billion consumer market. Following our strategic plan we have established multicultural marketing programs and small business centers in key cities to reach out to minority markets and businesses. We've also established programs to improve diversity at the Postal Service including one to increase our minority workforce and to increase the number of minority suppliers who do business with us. We've started our Dinero Seguro/Sure Money money transfer service so consumers have a safe, rapid and guaranteed way to send money to family and friends in Mexico. We may expand this service to several other countries including the Dominican Republic, the Philippines and El Salvador. It just makes good business sense to do all that we can to work with this market and serve it better.

We want to run the most efficient organization possible while delivering the highest customer satisfaction. Everything we do is aimed at helping us run our business more efficiently and serving our customers better. We make over 650 million deliveries each day, and we want to make sure that in delivering every piece of mail reliably, securely, and promptly, we do it as efficiently as possible.

M. Richard Porras

M. Richard Porras
Chief Financial Officer and Senior Vice President

62,000 mail handlers

Every one of our 62,000 mail handlers move an average of 3.2 million pieces of mail per year.

Management Discussion and Analysis

Overview

Although we are not required to file a financial report with the Securities and Exchange Commission (SEC), we include a Management Discussion and Analysis (MD&A), an SEC requirement, in our annual report. According to SEC regulations, the MD&A should give the reader "an opportunity to look at the company through the eyes of management by providing a short- and long-term analysis of the business of the company." In our discussion, we have attempted to comply with the latest SEC guidance for an MD&A written in plain language.

Our MD&A contains two major topics: Operations, and Liquidity and Capital. In Operations, we discuss Income, Revenues, Expenses and Other Issues. In the Income section, we discuss our net income and the sources and amounts of our contributions by our core classes of mail. With net income of $550 million we had an outstanding year in 1998. This followed our successes of almost $1.3 billion in 1997 and nearly $1.6 billion in 1996. In relation to our net income, we discuss the rate-setting process that Congress has established, a process that exercises significant control over our revenues. We also discuss equity restoration. Finally, in this section we discuss our Economic Value Added (EVA) program, which is a tool that we use to measure and manage our financial performance, allowing us to become more efficient in everything we do.

"The Postal Service has an enormous impact on this country, be it the economy or the community. Every two weeks, we inject approximately $1.6 billion into the economy in the form of salary and benefits to our employees. It's those employees who deliver hope in their communities by participating in food drives, becoming marrow donors, or reaching out to help in times of need."

Michael S. Coughlin
Deputy Postmaster General

In the Revenue section, we discuss our revenue by our core classes of mail. Three products—First-Class Mail, Priority Mail and Standard Mail (A)—account for over 90 percent of our volume and contribution. Revenue from First-Class Mail grew 1.8 percent, 7.6 percent from Priority Mail and 6.8 percent from Standard Mail (A) in 1998 compared with 1997.

In the Expenses section we discuss the two operating expense categories—personnel Compensation and Benefits, and Transportation—that make up almost 84 percent of our total expenses. During 1998 we controlled these costs and held them to an increase of 4.0 percent. Even though our workload increased and we have improved our service, personnel compensation and benefits increased by 4.0 percent compared with only 2.7 percent over 1996. Both an increase in the amount of transportation and in the cost of transportation caused transportation expenses to increase 4.5 percent.

Finally, in the Other Issues section we discuss those issues that we think may significantly affect our financial condition. We discuss our service to the community with our Breast Cancer Research semipostal stamp, recent legislative activity including proposed postal reform, Postal Service productivity, the effects of classification reform, environmental matters, *CustomerPerfect!*, our Year 2000 preparations and inflation.

In Liquidity and Capital, we discuss our liquidity management program. We discuss our efforts to reduce the number of banks we use. In addition to managing our liquidity better, we have reduced our interest on debt almost 55 percent since 1996. And we have increased the flexibility of our debt portfolio, obtaining $10 billion in additional notes that we can borrow against with short notice from the Department of the Treasury, thus making borrowing easier and more economical. We also discuss our capital investment program. Under this program we will invest $17 billion in capital projects over the next five years designed to improve customer service while helping us operate more efficiently and economically.

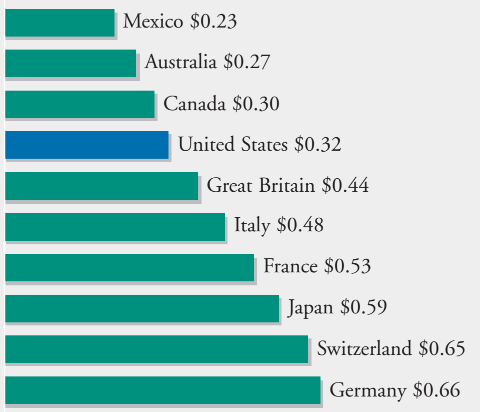
OUTLOOK

While you review our Management Discussion and Analysis, you will find it helpful to understand how we see the future of correspondence and the mail business. Providing mail services is a mature but growing business. Despite the fact that since 1832 the Postal Service and its predecessor the Post Office Department have lost market share, postal revenues have grown at the same average rate as the gross domestic product. We project total mail volume over the next decade will grow 3 to 4 percent a year, with First-Class Mail growing 1 to 2 percent a year. Many factors outside of our control such as population growth, competition, technological change, economic activity, residential demographic patterns, and the increasing value of people's time affect the growth in mail volume.

We know that we control our future by improving our service performance, keeping our costs down and our prices competitive. During the last seven years, postal prices have fallen in real terms, and our strategy is to continue to keep postal price increases below inflation over the next decade. Declining real postage prices contribute to increasing mail volume. Thus, our management incentives reward behavior that leads to declining real prices. Another way is to make large capital investments in technology to further automate how we do business, thus improving productivity

GLOBAL BARGAIN

comparative value of a First-Class stamp as of September 30, 1998



Considering our volume and the geographic area and population we serve, we are a global bargain.

and making us more efficient while improving our service.

The adult population (as measured by persons 22 years old or older) rose 50 percent from 1970 to 1995. During this same time, mail volume rose 113 percent. Since studies predict that the U.S. population will grow between 0.9 and 1.0 percent a year over the next decade, we believe our fundamental business will remain dynamic and that the Postal Service will continue to be the largest mail service organization in the world. For the short term, we expect modest growth in our overall markets. However, we also expect that our competitors will further erode our market, especially since they are not bound by the same regulatory restrictions and governmental mandates that bind us. These competitors are free to target profitable customers and sectors of the market while avoiding others. We, however, are required to serve everyone at the same price.

Technology will continue to put competitive pressure on our correspondence and transaction mail volume. Bills, statements and remittances (payments) represent $13 to $16 billion of revenue, with a very large contribution towards covering costs and net income. We monitor developments in this market very closely. We do not forecast a precipitous short-term revenue loss to alternative technologies such as electronic mail and bill paying. However, we know that for the long term such technologies present a serious threat.

Technology has also created opportunities. The increasingly sophisticated use of data allows businesses to go beyond using the mail as a targeted advertising medium to a personalized means of building lasting business relationships. Declining computing costs along with rapid innovation in database management and demographic analysis contributed to a rapid growth in mail volume in the 1980s. These developments, combined with the introduction of work-sharing discounts, which helped mailers take economic advantage of these trends, caused an explosion in mail volume.

Although providing postal services is not highly cyclical, economic activity does affect the demand for postal services. Current projections based on historical trends of the U.S. economy predict a steady expansion between 1998 and 2008. The basis for these projections is an average increase of 2 to 3 percent annually in the gross domestic product through 2008. While we would do better if the very strong economic trends of the last four years were to continue, our current operating assumptions are based on an economy that grows more slowly in 1999 than it has during the last four years.

We are monitoring the economy very carefully, because there are significant areas of concern. Starting with the June 1997 collapse of the Thai baht, there have been continuing currency crises in the emerging market economies, which have caused economies representing over 40 percent of global gross product to be in a recession or a depression. U.S. exports have dropped 10 to 15 percent. Loan losses abroad have reduced the lending ability of major banks, and their impaired capital could cause a credit crunch. This situation has caused us concern because the financial sector is important to the mail. The continued strength of the U.S. economy in 1998 was built on strong spending by consumers. This growth may be reaching its limits. A disappointing holiday season for retail purchases in 1998 could cause advertisers to rein in future expenditures.

Our discussion in the MD&A represents our best estimate of the trends we know about, the trends we anticipate, and the trends that we think are relevant to our future operations. However, actual results may be different from our estimates.

10,500 miles for just 32¢

You can send a letter the 10,500 miles from Bangor, Maine, to Koror, Palau, for just 32 cents. That's 32 millionths of one cent per mile.

"From the workroom floor to the front door of every customer, the Postal Service's greatest asset is the employees who make it all happen. In 1998, the men and women of the Postal Service processed 198 billion pieces of mail through our system, carrying on a tradition of delivering value. No other mail system in the world can match the efficiency or devotion of our employees."

John E. Potter
Senior Vice President,
Labor Relations

Income

In this section we discuss our net income for 1998 and explain the concepts of product contribution and volume-variable costs. We also discuss the rate-making process that determines our rate structure. (Please note that our approved rate increase is discussed in the Other Issues section.) And we discuss the progress of equity restoration, which we include in our rate structure. Finally, we discuss our Economic Value Added program, which we believe is helping us manage our resources better by changing employee behavior.

Our income depends on the rates we are allowed to charge, on the volume of mail we handle, and on our expenses. For a further discussion of the changes in our mail volume, see the Revenue section. For more details on our expenses, see the Expenses section.

NET INCOME AND CONTRIBUTION

Because we have not had a general price increase since early 1995, we consider this year's net income of $550 million to be a continuation of our financial successes of over a billion dollars of net income in each of the prior three years. This year's net income plus the nearly $1.3 billion in 1997 and almost $1.6 billion in 1996, gives us a three-year net income of almost $3.4 billion. This success is especially noteworthy because it is the first time that we have had four consecutive years of positive bottom line results.

Governor Winters noted this success in announcing a delay in implementation of new rates by saying, "This success has allowed us to return a dividend to the American public by extending stable rates for a full four years." The dividend is theoretically based upon the increase to our net income that would certainly have occurred had the Board of Governors implemented the general price increase at the same time they approved it in July of 1998. However, citing continued record delivery service and financial performance success, the Board chose to delay the rate increase for six months. The proposal to raise rates, Winters added, always has been about maintaining a solid, strong and universal Postal Service. "The rate adjustment is being made to provide a continuing investment in America's communications future. We need to continue investing in those things that will improve consistency in home delivery and improve and innovate services for American businesses."

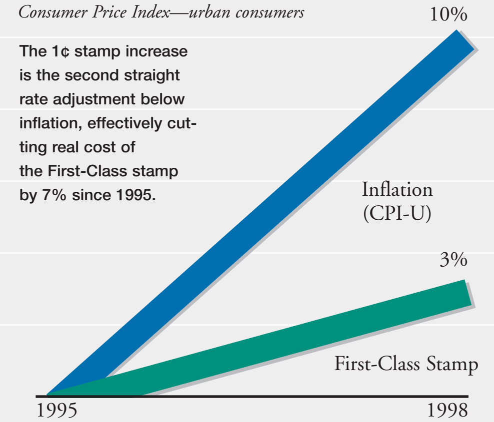
Our bottom line results are due to a combination of factors affecting our revenue and expenses. Operating revenue for 1998 increased almost $1.9 billion compared with 1997, an increase just slightly more than the $1.8 billion increase of 1997 over 1996. However, our 1998 increase in revenue did not offset our $2.9 billion increase in operating expense. This increase in expense was significantly more than the $1.8 billion increase of 1997 over 1996. Key factors in our growth in operating expenses were an increase of $1.8 billion in compensation and benefits in 1998, including a $554 million increase in workers' compensation expense, an increase resulting, in large part, from an upswing in the average cost per medical claim.

To put this year in perspective, our last general rate increase of January 1995 came after four years without an increase. Even then the increase was relatively small at only 10.3 percent. Between 1972 and 1998, the price of a postage stamp rose at only slightly more than prices in general, going up, on average, by about 5.5 percent per year, compared with an inflation rate averaging 5.3 percent, as measured by the Consumer Price Index for urban consumers (CPI-U). In fact, over the past seven years, the price of a stamp climbed significantly more slowly than prices as a whole, going up by only 2.1 percent per year, compared with an inflation rate of 2.7 percent annually.

We have prepared the chart on page 35 to illustrate the estimated 1998 contribution from various classes of mail. Contribution is the difference between revenue and volume-variable costs. As the term implies, volume-variable costs are those costs that vary directly or indirectly with

RATE OF INFLATION

Consumer Price Index—urban consumers



changes in mail volume. For example, a high percentage of mail processing costs are considered volume-variable costs since changes in mail volume directly affect the number of hours clerks and mail handlers have to work. On the other hand, only a small fraction of postmaster salaries are considered volume-variable costs since these costs are, for the most part, unaffected by changes in mail volume. In 1997, volume-variable costs totaled $32.2 billion, or about 56 percent of total costs. The remaining $24.8 billion of costs are nonvolume-variable and must be borne, ultimately, by the combined revenues of all classes of mail. When we say that First-Class Mail "contributes" $17.0 billion, for example, we mean that the postage collected from First-Class Mail exceeds the volume-variable cost of First-Class Mail by $17.0 billion.

Most of our product lines had modest volume increases in 1998. While we have introduced various new products to diversify our product base, their impact is minimal in relation to our core products. Our main core product, First-Class Mail, accounted for approximately 51 percent of our volume, 57 percent of our revenue and 66 percent of our contribution. Priority Mail accounted for less than 1 percent of our volume, almost 7 percent of our revenue and 8 percent of our contribution. Our bulk business mailers accounted for almost 42 percent of our volume, but only 23 percent of our revenue and 20 percent of our contribution. These three products combined to provide almost 94 percent of our volume and contribution. While we will continue to expand our opportunities for revenue growth, we focus on what we do best, which is our core business. We believe that our future success depends on an emphasis on personal accountability, service, effective use of resources, and product contribution.

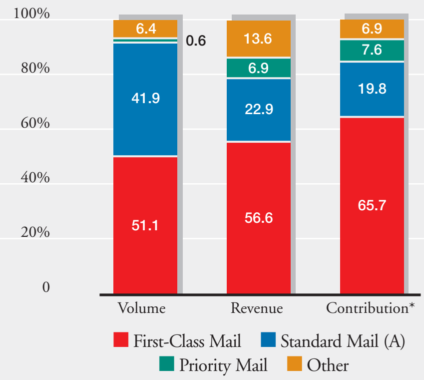
The Volume, Revenue, and Contribution chart shows contribution by class of mail. Together, First-Class Mail, Priority Mail, and Standard Mail (A) represent 93 percent of the total contribution. Half of our First-Class Mail contribution comes from single-piece mail.

RATE SETTING PROCESS

Until 1971, Congress set postage rates by law, with no relationship between the revenue from those rates and the actual cost of operating the postal system. Since 1971, however, the Postal Reorganization Act has required the Postal Service to establish postal rates that cover the costs of operating the postal system. To achieve this alignment of rates with expenses, the Act established a rate-making process that allows rates to be adjusted as necessary.

VOLUME, REVENUE AND CONTRIBUTION

by mail class (percentages)



** Projected from 1997*

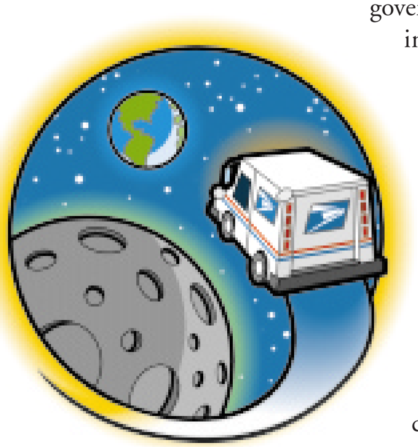
The rate-making process begins when management projects that current rates will not be adequate to meet our mandate of "covering costs" in the future. The Postal Service, upon concurrence with the Board of Governors, submits a request for a recommended decision on rate and fee changes to the Postal Rate Commission. (Like the Postal Service, the Commission is an independent establishment of the executive branch of the government.) As allowed by law, the Postal Service submits its request accompanied by detailed rate proposals supported by extensive testimony and documentation.

The Commission holds public hearings, allowing such interested parties as mailers, competitors, and consumer advocate groups to question the Postal Service's proposals and submit their own testimony and proposals. At the conclusion of the hearings, the Commission sends its recommended decision to the Governors. The Governors may approve, reject, allow under protest, or, under certain limited circumstances, modify the Commission's recommendations.

41%

We deliver 41 percent of the world's mail. The next largest is Japan, with 6 percent.

Although the Postal Reorganization Act requires the Commission to issue its recommended decision within ten months of the filing of the Postal Service's request, the entire process—starting with preparing the necessary documentation to support the rate proposals and ending with implementing the new rates—takes approximately 16 to 18 months. While this rate-making process has allowed us to bring revenues more in line with costs, this process offers us only limited flexibility in responding quickly to changes in our costs and in the markets in which we compete.



2,300 trips to the moon and back

NASA made six manned trips to the moon. Every year we drive 1.1 billion miles to move the mail. That's equivalent to 2,300 trips to the moon and back.

PRIOR YEARS' LOSS RECOVERY

By law, our rate-making process must produce revenue that at least covers our expenses. This means we must set rates to approximately break even. We should have maintained an equity balance transferred to us from the United States government when we were established in 1971. This equity balance plus subsequent capital contributions is approximately $3 billion. From 1971 to 1994 we did not maintain revenues equal to our expenses, and therefore, we did not maintain the $3 billion equity balance that was transferred to us. Indeed, by the end of 1994 we had almost $9 billion in cumulative net losses, making our net equity deficiency approximately $6 billion.

To understand why we must restore equity is to understand that equity is an important representation of a company's financial health. While private companies operate with negative equity only in unusual circumstances, government agencies often do so because they provide services without receiving any fees for those services. However, Congress gave the Postal Service a unique mandate. We must act like a business and, by law, our revenues must cover our costs. So, for us, equity is a measure of our financial health just as it is for private companies. In order to return the Postal Service to financial health, the Board of Governors adopted a resolution in July 1995 affirming our commitment to restore equity by recouping the losses we accumulated from 1972 to 1994. Beginning with the 1995 rate increase, $936 million per year is included in our rates so we can return to financial health. This recovery amount has been reduced to $377 million in the postal rate increase scheduled for January 1999.

ECONOMIC VALUE ADDED

Economic Value Added (EVA) is the measure we use to set our financial goals, determine whether a business strategy makes financial sense, evaluate our total financial performance, and reward employees by tying compensation to measurable performance. The EVA program, now in its third year, appears to be achieving the desired results: control costs and improve service.

In 1998 we began to index our EVA calculation, using 1997 as the base year. After determining net operating income, as defined for EVA purposes, and subtracting a charge for the capital we use to produce that income, we applied an indexing factor. The indexing factor removes the impact of postal price increases and inflation, giving us a true year-to-year comparison of our operating performance. Further, indexing eliminates the link between pay incentives and rate increases. It rewards postal employees for keeping rate increases below the rate of inflation.

Because EVA is a measure of operating results, it excludes financing costs such as interest and any unusual or nonrecurring transactions that are not part of the normal course of business. As a comprehensive financial measure, EVA gives us a single number representing both our operating results and how efficiently we use our assets. By measuring how efficiently we use our resources, we can determine how much value we have added to our business from one year to the next.

EVA emphasizes managing the business and creating value. It focuses our attention on increasing and improving our business, so that we produce long-term value by using our capital assets efficiently.

The total Economic Value Added from 1996 through 1998 is more than $2.4 billion.

A key to achieving continuous improvement is linking compensation with results. An integral part of our EVA system is an incentive payment system that rewards people for financial performance (as measured by EVA), customer service, and employee commitment. These incentives are tied directly to the EVA we generate. Creating EVA involves the efforts of each and every employee contributing to our financial and operating performance. We encourage our employees to find ways to reduce waste, control inventories and expenses, increase revenues, and operate equipment efficiently.

Our mission is to be a customer-driven business with products that provide the best value in the postal communications market. We think EVA is an important means for achieving that goal.

ANALYSIS OF OPERATING REVENUE

(dollars in billions)

	1998	1997	1996
First-Class Mail	$33.98	$33.40	$33.12
Standard Mail (A)	13.75	12.88	12.18
Priority Mail	4.15	3.86	3.32
Standard Mail (B)	1.63	1.63	1.52
International Mail	1.60	1.61	1.65
Other	4.96	4.84	4.61
Total operating revenue	$60.07	$58.22	$56.40

Revenue

In this section we present our revenue results for 1998, compare these results with 1997 and 1996 and discuss trends that we believe to be important. These trends represent our best judgments, actual results may vary from our estimates.

GENERAL

America is peculiar among the world's nations because it has a large and increasing portion of its population clustered in demographically homogenous residential centers. This concentration, combined with population mobility, makes it difficult for broad-based advertising media to target specific audiences. Thus, the mail is the premium medium for targeting specific audiences, giving it a competitive advantage. Moreover, we think that the baby boomer population will continue to be the major economic force in the mail services we deliver. According to the Household Diary Study, First-Class Mail peaks in the 45-64 age group and Standard Mail (A) in the 65-69 age group. We think that as these age groups increase and as they reach their maximum earning power, they are more likely to use traditional mail services, while the younger population may be more likely to switch to alternative postal services.

Reinforcing these demographic patterns is the increasing value of people's time. To the extent that the mail can help consumers shop from home and save time, we see further opportunity for growth in our services. And, as businesses strive to reduce labor costs, we see the mail offering an inexpensive way to build relationships while replacing expensive face-to-face communication.

OPERATING REVENUES

Our operating revenues for 1998 maintained the same level of growth as the increase from 1996 to 1997. At $60.1 billion, 1998 Operating Revenue was up 3.2 percent. First-Class Mail, which constitutes our largest revenue and volume category, grew 1.8 percent in revenue on a 1.5 percent growth in volume. Standard Mail (A) revenue increased 6.8 percent on a 7.3 percent increase in volume. Revenue for Priority Mail increased 7.6 percent on a 9.0 percent increase in volume, while revenue gains in our other classes of mail were more modest. We expect volume to continue to grow in 1999, with revenues growing proportionally in most classes of mail. Overall, for 1999 we expect revenue to grow approximately 4.9 percent, with Priority Mail and Standard Mail (A) leading that growth. This growth will track volume increases, expected to put us over 200 billion pieces of mail in 1999 and to a lesser extent our rate increases.

We get over 60 percent of our mail through our bulk mail entry units, so we can identify this revenue according to classes of mail. For most other mail, we use a sophisticated sampling system that allocates the revenue from this mail to classes. However, this process is not available in final audited form until after our year end.

During the year, we use a number of sources of data to update the models that estimate our revenue by class of mail, the number of pieces of mail we handle, and the weight of the mail. Some of our analysis and data in this section comes from those models.

CLASSES OF MAIL

We offer a variety of products to meet our customers' needs. Our primary products, based on percentage of total revenue, are First-Class Mail (56.6%), Standard Mail (A) (22.9%), and Priority Mail (6.9%), which combine to make up over 86 percent of our total revenue, which is approximately the same percentage as 1997 and 1996. With these classes we can offer our customers a unique bundle of services that enable them to choose the service and price that best suits their needs. We discuss each of these classes of mail below.

First-Class Mail

First-Class Mail, which includes personal correspondence, post cards, small parcels, and business transactions, is a mature product which had volume growth of 1.5 percent and revenue growth of 1.8 percent in 1998. While the increase in revenue was in line with what we had projected, the increase in volume was less. The less-than-expected volume growth was largely due to the decline in single piece mail volume. This decline was partly offset by the growth in the Presort category. Presort letters and flats make up 40 percent of the First-Class volume and have had an average growth rate of 4.9 percent per year since 1995. We believe that the slowdown in volume growth was due to two factors: the Classification Reform of 1996 and the electronic diversion of mail.

In 1996, we changed our mail classification structure. (Classification is the rules and regulations that specify what type of mail can be sent in a particular class.) As a result of the changes in the classification structure, mailers were able to use lower cost classes of mail. While we expected mailers

"Our customers, large and small, look to the Postal Service as a trusted third party to meet their individual mailing needs. We are improving our products and services so that whether it's making sure millions of catalogs arrive in time for a big sale or that a loved one receives a birthday card on time, we continue delivering on our promise every day."

Allen R. Kane
Chief Marketing Officer &
Senior Vice President

to take advantage of these changes to shift their mail within and between classes of mail, we did not know exactly how much our mail volume in each of the classifications would change.

The effects of classification reform continue, with a substantial shift in the volume of certain categories of First-Class Mail. There has also been a change in the relative growth rates between First-Class and Standard Mail (A), resulting in a lower growth in the volume and revenue of First-Class Mail, and a higher growth in the volume and revenue of Standard Mail (A). In 1997, First-Class Mail volume grew 1.5 percent, while revenue grew 0.8 percent. In 1998, volume grew 1.5 percent, continuing the trend of smaller than expected volume growth. Revenue grew 1.8 percent, up slightly from 1997.

In addition to the effects of classification reform, we believe that the expanding use of electronic media will also affect the growth in volume and revenue of First-Class Mail. While it is difficult to determine exactly how much First-Class Mail has been lost to electronic mail, automated transfer of funds, electronic data interchange, automated bill payments, and facsimiles, it is clear that some mail has been lost to these alternatives. The use of these alternatives will continue to affect the growth in the volume of First-Class Mail. For example, the United States Treasury will soon require that approximately 7 million companies pay their business taxes electronically, resulting in 160 million electronic transfers. In addition, both the federal government and most state governments have plans to make benefit payments by electronic transfer and not by check. We expect to lose significant First-Class Mail revenues as a result of such changes.

On a per-piece basis, First-Class Mail costs have shown little change in recent years and actually declined nearly 2 percent from 1996 through 1997 from 16.7 cents to 16.4 cents. This decline occurred in spite of an increased focus on First-Class Mail service performance. Although 1998 costs by class of mail are not available at this time, First-Class Mail unit cost growth is expected to remain moderate.

Standard Mail (A)

Standard Mail (A) includes advertising letters, flats and small parcels. Standard Mail (A) is predominantly presorted mail. Because Standard Mail (A) typically is substantially less expensive per piece than First-Class or Priority Mail, it is used by mailers whose primary concern is the cost of mailing. In order to use this class of mail, mailers must meet specific volume and content requirements. Presorted Standard Mail (A), or bulk mail, as it is often called, is subdivided into four subcategories: regular, nonprofit, enhanced carrier route (ECR), and nonprofit enhanced carrier route (non-ECR).

ANALYSIS OF MAIL VOLUME

(pieces in billions)

	1998	1997	1996
First-Class Mail	101.17	99.66	98.22
Standard Mail (A)	82.87	77.25	71.69
Priority Mail	1.16	1.07	0.94
International Mail	0.94	1.01	1.05
Standard Mail (B)	0.97	0.99	0.95
Other	10.83	10.91	10.59
Total mail	197.94	190.89	183.44

The volume of Standard Mail (A) grew 7.3 percent from 1997 to 1998, compared with a 7.8 percent increase from 1996 to 1997. This volume growth was more than twice our expectation of a 3.6 percent volume growth in 1998. Revenue grew 6.8 percent from 1997 to 1998, compared with the 5.8 percent increase from 1996 to 1997. The growth in Standard Mail (A) comes from both the ECR and non-ECR categories, with additional growth from non-ECR. Nonprofit ECR, on the other hand, consistently declined since 1995. Because Standard Mail (A) is particularly effective in reaching discrete target markets, advertisers and direct marketers are expanding their use of this class. Also, as we discuss above, we believe that many mailers have increased their use of Standard Mail (A) compared with First-Class Mail as a result of the 1996 classification reform. This change, which we expected, partially explains the strong growth in Standard Mail (A) from 1996 to 1997, and also from 1997 to 1998. We anticipate that volume growth in this category will remain in the 3 percent range.

Standard Mail (A) competes with a variety of advertising alternatives, including newspapers, television, radio, and telemarketing. We believe that advertising on the Internet poses a threat to the continued growth in the volume and revenues from Standard Mail (A).

As was the case with First-Class Mail, the per-piece cost of Standard Mail (A) actually declined from 1996 to 1997. Growth in costs on a unit basis is expected to remain moderate in 1998.

Priority Mail

Priority Mail, our most popular expedited delivery service, provides two- to three-day delivery of documents and parcels. We support Priority Mail with what we think has been an extremely effective advertising campaign that has positioned it as a sensible alternative to high-priced, next-day products offered by a variety of companies. We think our advertising campaign is responsible for a portion of the growth in volume and revenue for this class of mail. With volume growth of 9.0 percent and revenue 7.6 percent over 1997, it is our fastest growing class of mail. However, we had anticipated a 10.0 percent volume growth in 1998. While this growth is lower than the 14.0 percent growth in volume and 16.1 percent growth in revenue for 1997, we think that part of that growth was due to the strike at United Parcel Service and that the growth in this class of mail will return to the 1995 to 1996 level of about 10 percent.

The unit costs of Priority Mail grew 4.1 percent from 1996 to 1997, slightly faster than the rate of inflation. Priority Mail operations have undergone substantial change in recent years with the expansion of dedicated seasonal air transportation and the implementation of the Priority Mail Processing Centers. Given these substantial changes, it is not possible to estimate the trend in Priority Mail unit cost for 1998. Nevertheless, management is committed to providing improved service for Priority Mail, including further implementation of delivery confirmation in 1999.

Standard Mail (B)

Standard Mail (B) is primarily parcels (Parcel Post) and Bound Printed Matter. In 1998, volume decreased 1.7 percent and revenue decreased 0.1 percent, which are substantially lower than the volume growth of 4.2 percent and revenue growth of 6.8 percent in 1997. In 1998, we expected a 5.5 percent volume growth in this category. However, our 1997 results were significantly affected by the strike at UPS. When we compare our 1998 results with 1996, we see that volume increased 2.4 percent, or roughly 1.2 percent per year, and revenue increased 6.7 percent, or roughly 3.3 percent per year. We expect volume in this class to continue to grow at approximately this same rate.

After a unit cost decline in 1996, Standard Mail (B) costs increased by 10.0 percent in 1997, which is partly reflective of extraordinary efforts to respond to mailer needs during the UPS strike. Industry adoption of drop-shipping increased in 1998, and this trend is expected to continue into 1999 with the implementation of new pricing incentives for entry of parcel post at Processing and Distribution Centers and Delivery Units.

Periodical Mail

Periodical Mail includes subscription magazines, newsletters, and newspapers. The delivery of this mail is a central part of our public service charter, and it is an important class of mail both for the people who order and look forward to receiving these publications and for the publishers who use our services to deliver them. In 1998, volume decreased 0.9 percent and revenue grew 0.2 percent compared with 1997, which is substantially lower than the volume increase of 2.8 percent and revenue growth of 2.7 percent in 1997 compared with 1996. Historically, Periodicals volume has declined on a per capita basis as competition for the attention of the American public has intensified with the emergence of broadcast television, cable television, and most recently, the Internet as sources of news and information.

Although the unit cost of Periodicals mail was nearly unchanged in 1997, the Postal Service is responding to industry concerns over unit cost growth and complaints of poor service performance, particularly for small circulation periodicals. Improved flat sorting technology is expanding the availability of low-cost automated piece distribution to a wider variety of Periodicals. Additional technological advances will increase the speed and lower the cost of automated flats distribution operations. The National Periodicals Service Improvement Task Force is working on a variety of service solutions involving mail makeup changes, mail acceptance and information systems. Additionally, the Postal Service is developing training tailored to Periodicals mailers so they, too, can benefit from efficiencies resulting from the best mail preparation methodology.

International Mail

Rigorous competition and a weak international economy adversely affected international mail volumes in 1997. This trend continued during 1998. From 1997 to 1998, revenue declined 1.0 percent on a volume decline of 6.3 percent.The largest decline was in single piece mail—letters, cards, parcel post and others (technically LC, AO and CP). Three primary factors explain the decline: the adverse financial implications associated with the economic conditions in the Pacific Rim countries; the entrance of foreign postal administrations in the North American market; and the widespread use of the Internet. The Internet may explain a significant drop in mail to Canada. Overall, income was positive, exceeding 1997 by 5 percent. The increase in income was due primarily to lower expense levels. Two business products contributed to these results, Global Priority Mail (GPM) and International Priority Mail. Revenue increased 73 percent for GPM between 1997 and 1998.

Global Priority Mail reaches 33 countries around the world.

Expenses

Our discussion of Operating Expenses will focus on the two operating expense categories that make up almost 84 percent of our total expenses in 1998. These categories are Personnel Compensation and Benefits, and Transportation. Although not discussed here, interest on deferred retirement liabilities relates to the impact of changes to Personnel Benefits. The chart on page 43 presents the relative proportions of our major expense categories.

"Many people don't realize what it takes to move the mail. Letter carriers, clerks, mail handlers, supervisors, drivers, and many others, work around the clock, 365 days a year, to ensure the safe delivery of the mail. It's an awesome task and a great responsibility which we carry out with great pride and dedication."

Clarence E. Lewis, Jr.
Chief Operating Officer and
Executive Vice President

COMPENSATION AND BENEFITS

Personnel compensation and benefits grew $1.8 billion or 4.0 percent over 1997 due to contractual wage increases, a 1 percent growth in workhours, and workers' compensation expense that was greater than last year. This compares with a growth of 2.7 percent in 1997 over 1996. In 1998, base salaries alone increased almost $1 billion.

Most employees covered by our collective bargaining agreements in 1998 received a 1.2 percent general wage increase and semiannual cost of living adjustments (COLAs) of $167 and $208. In addition to receiving merit adjustments, lump-sum payments for individual performance, or both, most of our professional and management staff participated in the Postal Service's Economic Value Added (EVA) funded group incentive program.

An increased workload due to growth in mail volume, an expanding delivery network, and improvements in customer service along with contractual pay increases will drive compensation and benefits growth in 1999. Our current labor agreement with the National Rural Letter Carriers' Association will expire in November 1999. The terms of this agreement include a $400 lump sum payment in November 1998 and two COLAs in 1999.

Our contracts with the American Postal Workers Union and the National Postal Mail Handlers Union expired on November 20, 1998. However, we reached tentative agreements with both of these unions on December 2, 1998. The new agreements call for a 2 percent general pay increase plus two cost of living adjustments in 1999. These agreements must be ratified by each union's members. We have not yet concluded a new agreement with the National Association of Letter Carriers whose contract also expired in November 1998. Most of our nonbargaining employees will again participate in our merit pay and variable pay programs, which base compensation on individual and group corporate performance aligned with the *CustomerPerfect!* process.

RETIREMENT EXPENSES

We participate in a multi-employer retirement system. Essentially, our employees participate in one of the three retirement programs, under the auspices of the United States government's Office of Personnel Management (OPM), based on the starting date of their employment, as detailed in Note 6 of the Notes to Financial Statements.

Employees hired before January 1, 1984, are covered by the Civil Service Retirement System (CSRS). Approximately 38 percent of our employees are covered by CSRS. Employees with prior government experience hired between January 1, 1984, and January 1, 1987, are covered by the Dual CSRS/Social Security System. Approximately 2 percent of our employees participate in the "Dual" system. Employees hired on or after

MAIL PER CAPITA, REVENUE AND EXPENSE
(in units indicated)

	Years ended September 30,		
	1998	1997	1996
U.S. resident population July 1 estimate (in millions)	270.26	268.21	265.76
Percent change	0.8%	0.9%	0.9%
Pieces of mail per capita	732	712	690
Percent change	2.9%	3.1%	0.5%
Total operating revenue per capita	$222.27	$217.05	$212.23
Percent change	2.4%	2.3%	2.9%
Total operating expense per piece of mail	$0.2919	$0.2875	$0.2895
Percent change	1.6%	-0.7%	3.2%
Total operating revenue per piece of mail	$0.3035	$0.3050	$0.3075
Percent change	-0.5%	-0.8%	2.4%
Net income per piece of mail	$0.0028	$0.0066	$0.0085

January 1, 1984, with the exception of Dual employees and CSRS employees who have switched plans, are covered by the Federal Employees Retirement System (FERS). FERS employees are 60 percent of our total.

For the second consecutive year, the new layer arising from increases in basic pay for our CSRS employees was less than our annual payment to the OPM, resulting in a decrease to retirement liability. We attribute this trend, which we expect to continue, to both the declining number of employees covered by CSRS and to lower increases in basic pay.

Because of low inflation, the layer arising from cost of living adjustments was less than in prior years. However, even with low inflation, we expect the new layers to be larger than our annual payments on the liability because our retiree/survivor population will increase, as will the proportion of their government service attributed to the Postal Service. Thus, we expect this liability to continue to grow over time.

In 1997, Congress approved a six month open season for workers covered by CSRS to switch to FERS. This open season ran from July 1998 to December 1998. While the final number of employees who chose to change systems was not determined at the time this report was prepared, preliminary figures showed only three-tenths of 1 percent of our employees had chosen to change to FERS. Based on this preliminary figure, we anticipate that less than 1 percent of our employees will make the change. The financial impact of this open season will be minimal.

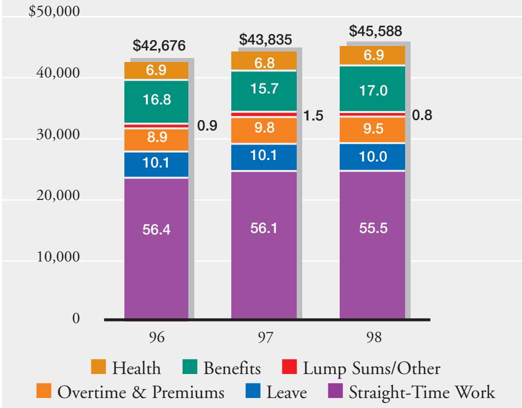
The following table describes our retirement contributions as a percent of an employee's pay.

	FERS	CSRS
Basic Annuity	10.7%	7.0%
Social Security	6.2%	0.0%
Medicare	1.45%	1.45%
TSP	5.0%	0.0%

We have omitted CSRS deferred retirement expense from this table. Our year-end payment to OPM, including interest, was $3.3 billion for our CSRS deferred retirement liability. We have no deferred retirement expense for FERS employees. This amount does not include $347 million we paid for retroactive COLAs and health benefits. We discuss these contributions in more detail in Notes 4 and 6 of the Notes to Financial Statements.

PERSONNEL COMPENSATION AND BENEFITS

(dollars in millions, percentages)



While all employees may participate in the Thrift Savings Plan (TSP) as administered by the Federal Retirement Thrift Investment Board, the rules for participation are different for each group of employees. We do not match CSRS or Dual contributions to the TSP, and contributions are limited to 5 percent. However, we are required to make a contribution of 1 percent of basic pay to the TSP for FERS employees. In addition, we fully match employee contributions between 1 percent and 3 percent, and we match 50 percent of employee contributions between 3 and 5 percent.

We fully fund FERS, the Dual and CSRS systems according to OPM stipulations. But since the estimated long-term liability created by the increases to the basic pay for CSRS employees exceeds the legal funding requirements of the Postal Service, we record a deferred retirement liability on our books.

We are liable for the estimated increases in the deferred retirement liability of the CSRS Fund that are attributable to Postal Service employee/management agreements that increase employees' basic pay.

one million more

In 1998, we delivered mail to almost one million more addresses than in 1997.

WORKERS' COMPENSATION

Under federal law, when postal employees are injured on the job, they are entitled to workers' compensation benefits. This means that we pay their lost wages and any medical bills related to their on-the-job injuries. Since we do not maintain workers' compensation insurance, we make such payments out of our own funds. Thus, our bottom line is affected every time an employee is injured and unable to return to work.

In fact, accounting rules require that, if an employee is receiving workers' compensation, we must record a liability for the present value of all his or her expected future payments. Excluding claims relating to the operations of the old Post Office Department, the current average liability per employee claim for lost wages is about $165,500 and the average liability per employee claim for medical bills is about $9,400. In 1997, the average liabilities per claim were about $165,000 for lost wages and $8,100 for medical claims. At the end

198,000,000,000

We delivered 198 billion pieces of mail in 1998.

of 1998, we estimate our total liability for future workers' compensation costs at $5,287 million. At the end of 1997, this liability was $5,092 million. In 1998, we recorded $760 million in workers' compensation expense compared with the $206 million we recorded in 1997. We attribute the increase in expense, in large part, to increases in average cost per medical claim.

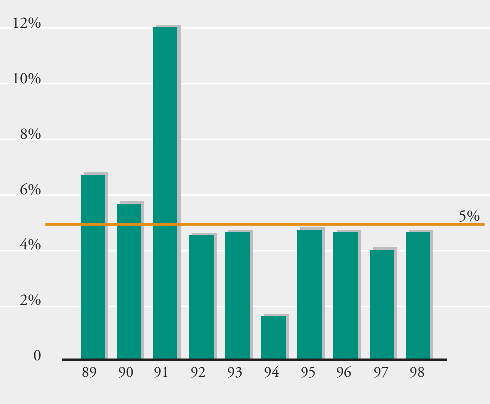
In the past, workers' compensation expenses tended to increase every year as more and more employees received payments for lost wages and medical treatment. Once injured employees were put "on the rolls," they tended to stay there. As recently as 1992, our annual workers' compensation costs exceeded $1 billion. So we formed a task force to return to work all employees who are able to return. The task force has worked hard to return employees to work and to terminate compensation for those employees who are able to work but who refuse valid job offers. This program continues, in expanded form, as the Return to Work Initiative. Our goal is to reduce the long-term periodic rolls by closer collaboration between postal medical and postal injury compensation personnel and to manage new injuries from the date of the injury or when we are notified. We have made other savings by auditing medical bills for duplicate payments and for inpatient overbillings when compared with state fee schedules. However, both the Return to Work Initiative and the auditing program will not affect our workers' compensation costs as much in the future as they have in the past. Many of the high-potential candidates for rehabilitation have already returned to work. Also, many of the large hospital bills have already been audited. Moreover, overall responsibility for this function rests with the Department of Labor, which is now in the process of seeking approval for implementation of a federal inpatient fee schedule similar to that used for Medicare. However, we will continue to audit medical bills for duplicate payments.

Our greatest opportunity for containing our workers' compensation expense is on "the front end" in the prevention of injuries. We have continued with an intensive study of how and where we work in order to identify anything that might contribute to the possibility of a worker being injured. Our back-to-basics program called Second-to-None establishes a formal methodology to track progress in creating a safer working environment. In addition, an important objective of our capital investment program is to add equipment that will reduce the number of on-the-job injuries. Consequently, in 1998 we saw the second consecutive decrease in the number of injuries we reported to the Department of Labor.

We believe that the emphasis on early and proactive case management is critical when an injury occurs. In this regard, we are refocusing our efforts on early claims management. In prior years, we hired additional employees to research claims for workers' compensation, increased the funding for fraud investigations, added 25 postal inspectors for fraud investigations and implemented the Nurse Coordination Program (NCP). Next

Expense growth has been held to under 5 percent for seven straight years.

TOTAL EXPENSES (1989–1998)
(percent change)



ANALYSIS OF EXPENSES

(in percent)

	1998	1997	1996
Personnel compensation	58.28%	59.47%	59.24%
Personnel benefits	18.27	17.35	18.39
Transportation	7.06	7.05	6.80
Supplies and services	5.15	3.91	4.10
Interest on deferred retirement	2.68	2.80	2.64
Depreciation and write-offs	2.71	2.99	2.45
Other	1.69	1.72	2.14
Rent and communications	1.64	1.52	1.47
Vehicle/building maintenance	1.00	0.96	0.92
Utilities	0.73	0.77	0.75
Advertising	0.51	0.47	0.43
Interest	0.28	0.54	0.67
POD workers' compensation costs	-	0.45	-
Total	100.00%	100.00%	100.00%

year, we will be expanding this program to an additional 30 sites. This pilot program uses early nurse intervention to assist in the return of claimants to productive work. We believe that this program will succeed in reducing compensation claims costs in the long run, despite the anticipated short-term increases in medical costs.

We remain serious about managing our current claims and preventing new claims. In 1999, we will make additional funding available to our field offices for local cost control efforts. We also remain serious about eliminating fraudulent claims. We are so serious, in fact, that we now offer a reward of $10,000 to anyone who gives us any information that leads to the arrest and conviction of any current or former employee, or medical service provider, who has defrauded the workers' compensation program. Anyone with any such information can make a confidential call to the Office of the Inspector General at 1-800-654-8896.

Under the Postal Reorganization Act of 1971, the U.S. government remained responsible for the payment of all workers' compensation claims for workers who were injured while working for the old Post Office Department. Under this Act, the newly created Postal Service would be responsible only for its own workers' compensation claims. However, in the Balanced Budget Act of 1997 Congress transferred the old Post Office workers' compensation costs to the Postal Service. We estimate the present value of these claims to be $231 million and have recorded this year's expense of $8 million.

TRANSPORTATION

Our transportation expenses grew because of an increase in our mail volume and our concentrated efforts to improve two- to three-day First-Class service. Our transportation expenses increased $181 million or 4.5 percent, compared with 1997. This compares with an increase of $290 million or 7.8 percent from 1996 to 1997.

The increase between 1997 and 1998 is due in large part to the increase in volume of mail handled. In 1998, we handled almost 198 billion pieces of mail, and in 1997 the number was almost 191 billion. That is an increase of over 7 billion pieces or 3.7 percent. Another reason for the increase is our new emphasis on improving our two- to three-day service levels. Improvement required us to increase the use of highway mail transportation systems in order to meet our scheduled delivery times. We have also shifted more mail to our highway hub system since for trips of less than 600 miles it is more efficient to use surface transportation. As long as we continue to improve our level of service and expand these systems, we expect our transportation costs to continue to grow.

Notably, our transportation costs did not increase this year at the same level as experienced between 1996 and 1997. This was primarily due to changing fuel prices. While fuel prices increased 7.6 percent between 1996 and 1997, they decreased 12.3 percent between 1997 and 1998. This decrease partially offset increases to our transportation costs due to efforts to improve service. Our transportation costs are also dependent upon our contract rates with major airlines and others who provide us mail transportation services, as these companies can pass along to us the increase in their labor and other costs.

293,000 letter carriers

41.5 tons of mail each

Each of our 293,000 letter carriers delivered an average of 41.5 tons of mail in 1998. That's equivalent to carrying ten average-sized male elephants.

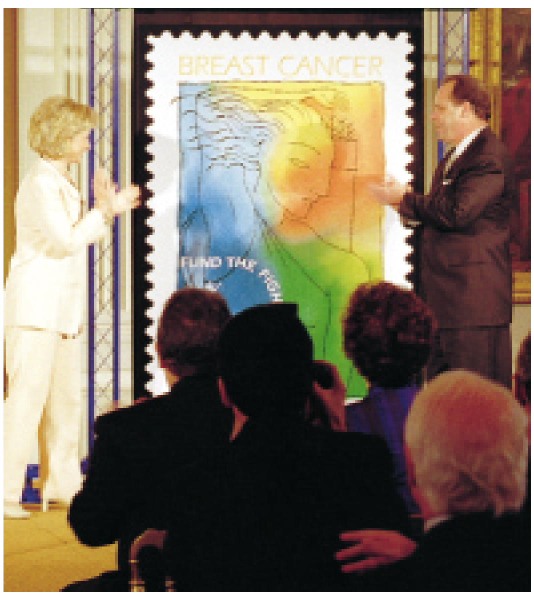
Other Issues

In this section we discuss the other issues that we think may affect us. We discuss the Breast Cancer Research semipostal stamp, recent legislative activity, productivity, recent postal legislation, recent classification reforms, environmental issues, *CustomerPerfect!*, our efforts to have our computers ready for the year 2000, and the effects of inflation.

Of course, we can't be sure that our views on the following issues are accurate, but the discussion represents our best judgment of what we think is relevant to our present and future operations. Actual results may well be different from our best estimates.

BREAST CANCER RESEARCH SEMIPOSTAL STAMP

On July 29, 1998, the Postal Service issued its Breast Cancer Research semipostal stamp. This is the first U.S. stamp whose net proceeds above the cost of postage are designated for research organizations. The Governors' established price of the stamp is 40 cents and is valid for postage up to the 32-cent First-Class letter rate. Seventy percent of the net proceeds above the cost of postage are assigned to the National Institutes of Health and 30 percent to the Medical Research Program of the Department of Defense. As of September 30, the stamp has produced revenues of almost $12 million, with almost $2.4 million in donations.



"This deadly disease, which claims a woman's life every 12 minutes, has touched the lives of so many American families…. This historic stamp will be invaluable in our efforts to increase research funding and save lives."

Hillary Rodham Clinton
First Lady

RECENT LEGISLATIVE ACTIVITY

In 1998, Congress passed legislation that applied private sector provisions of the Occupational Safety and Health Act (OSHA) to the United States Postal Service. Prior to the passage of the bill, the Postal Service followed OSHA guidelines applicable to other federal sector agencies.

Last year, the postal community had the opportunity to respond to provisions and revisions of postal reform legislation introduced by Congressman John McHugh, Chairman of the House Subcommittee on the Postal Service. Consideration of Chairman McHugh's bill will resume upon reintroduction in the 106th Congress.

PRODUCTIVITY

We use several measures to track productivity. One of these is the Total Factor Productivity (TFP) measurement system. This system measures the changes between outputs and the resources used to produce the outputs and provides a means to measure productivity over time. A comparable measure of productivity in the private sector is Multifactor Productivity (MFP) for nonfarm business, which is reported by the Bureau of Labor Statistics. TFP is best used to analyze long-term trends and is not effective as a short-term measure or snapshot in time.

Our goal, as outlined in our Five-Year Strategic Plan, is to improve our TFP over time at a rate that at least equals or exceeds any improvement in the private sector MFP. Postal Service Total Factor Productivity since 1990 has increased at an average annual rate of 2.3 percent, which compares with the 2.6 percent gain reported for MFP. The gap between these two numbers illustrates the danger of using a statistic without reviewing the trend behind it. Last year we were ahead of the private sector, but because we increased our capital investments and converted many transitional employees to career status we have a temporary fluctuation in our TFP. This fluctuation is a lag between the capital investments we have made to improve productivity and the savings we have yet to realize from these investments. TFP is best used to analyze long-term trends and is not effective as a short-term measure or snapshot in time.

We balance our objective to improve our productivity with our objective to improve customer service. Because our TFP does not include a measure of service quality, our TFP may decline in the short term because some of our investments improve service but do not improve productivity.

CLASSIFICATION AND RATE CHANGES

In 1998, the Governors approved a new rate structure that increases rates an average of 2.9 percent, the smallest rate increase in our history. The new rate structure also provides increased economic incentives for our customers to prepare their mail in ways that reduce our costs and help hold down rate increases. However, the Board voted to delay implementing the new rates until January 10, 1999. The new rates include a one-cent increase for First-Class letters as requested by the Postal Service. The rates for other classes of mail will also increase modestly: 5.6 percent for Priority Mail, 8.1 percent for Express Mail, 4.6 percent for Regular Rate Periodicals, 6.8 percent for Nonprofit Periodicals, 3.5 percent for commercial Standard (A), 8.7 percent for nonprofit Standard (A), 12.4 percent for Parcel Post, and 11 percent for special services. In addition, we can now offer new worksharing rate categories for Parcel Post and delivery confirmation for Priority and Standard (B) mailers. Also, we will now be able to offer our Parcel Post customers the same discounts we presently offer our Periodical and Standard (A) customers for barcoding, presorting, and drop-shipping their mail. And we will be able to offer the parcel shipping public delivery confirmation, signature service, and bulk insurance.

Generally, the new rate structure provides more opportunities for our customers to reduce their mailing costs, while it allows us the opportunity to offer our customers new services. We can now offer our Periodical customers a new presort discount, and our Standard (A) customers can reduce their costs by using more barcoding. In addition, the rates for bound printed matter have been revamped to better reward those customers who transport their mail closer to the point of delivery.

In June, the Board of Governors approved a filing with the Rate Commission to test market the experimental versions of Mailing Online service. Mailing Online allows customers to send electronic documents and mailing lists to the Postal Service via the Internet. The system then transmits the documents to private printers who produce automation-compatible mail pieces for entry at designated Postal Service facilities. The market test, which will be conducted in the Northeastern United States, will test customer acceptance, while allowing us to gain experience in providing the service at multiple locations on a national level. Hearings on our request were held in August 1998, and we hope to have a Recommended Decision in time for a national introduction of the service in 1999.

The Commission also issued its Recommended Decision on Provisional Packaging Service affirming the legal basis for the Postal Service's introduction of the service. This new service will offer customers the convenience of having their parcels packaged and mailed at one location. However, in addition to recommending fees higher than those proposed by the Postal Service, the Commission imposed a requirement that the Postal Service indemnify all articles sent via Pack and Send against damage. Because of these recommendations, we will study this proposal further before deciding whether we implement this service.

ENVIRONMENTAL MATTERS

Because we want a safe and healthy environment for our employees and customers, we have set high goals for our environmental policy, and we are meeting them. In 1993, we developed our Environmental Strategic Plan, which focuses on leadership and compliance. Since 1995, we have received 24 White House "Closing the Circle Awards" for our pollution prevention and recycling accomplishments. During 1998, we recycled about 1 million tons of waste paper, cardboard, plastics, cans and other material. These recycling activities generated about $4 million in revenue.

We promote pollution prevention, we do all that we can to reduce waste, and we recycle and reuse materials wherever possible. In 1998 we expanded our use of linerless labels. We expect to save $40 million from using these labels, as well as avoiding the generation of 678 tons of scrap paper waste. We use recycled materials for our products. We use "green products" to maintain our equipment, and we are a national leader in the use of re-refined oil and retreaded tires. We buy over 100,000 retreaded tires each year for our vehicles, and we use re-refined oil in over 100,000 vehicles.

We are an industry leader in using environmentally friendly packaging materials for our Priority Mail service. We use a paperboard envelope that is 100 percent recycled with a minimum of 80 percent postconsumer fiber. Our envelopes also have no impediments to recycling such as a plastic document window. A report by The Alliance for Environmental Innovation and a letter from the Federal Environmental Executive to the General Services Administration (GSA) have both suggested expanding use of Express Mail based on our environmental record.

"We continued to move forward this year on the people side of the business. Now more than ever employees and management are working together to try new approaches. For example, a new system of dispute resolution, bringing in a neutral third party to help resolve EEO issues, has had very positive results."

Mary S. Elcano
Senior Vice President and
General Counsel

A recent study found that the use of Standard Mail (A) has very positive environmental benefits. Standard Mail (A) consists of advertisements from mail order companies, publishers, department stores, and financial institutions. This mail produces an estimated net economic benefit of $275 million per year in environmental impact. The study found that because consumers used Standard Mail (A) to shop from home, they made fewer automobile trips to stores, thus reducing pollution, the amount of gasoline consumed, and other environmental benefits.

In Ft. Worth, Texas, we are building an experimental retail and delivery station with recycled materials, drought-resistant native landscaping, high-efficiency heating and cooling systems, anti-glare full-spectrum lighting, skylights for natural lighting and trellises for shading. The interior wall panels are made of recycled wood glued together and filled with straw insulation, while recycled materials taken from old highways are used in the concrete. Structural beams are made of recycled steel, and a roof-mounted water collection system will provide rainwater for the landscaping. The exterior paint and the roof are designed to reflect light and reduce heat. This building will provide us with a test site where we can compare cost, performance, maintenance and aesthetics to standard construction. What works can then be incorporated into other buildings.

seven million

Every business day 7 million customers visit our post offices.

We are involved in various litigation and have unresolved claims pending related to environmental matters. We believe that we have made adequate provision in our accounts for the amounts which may become due under these claims. We are of the opinion that such liability is not likely to be of significant importance in relation to our accounts.

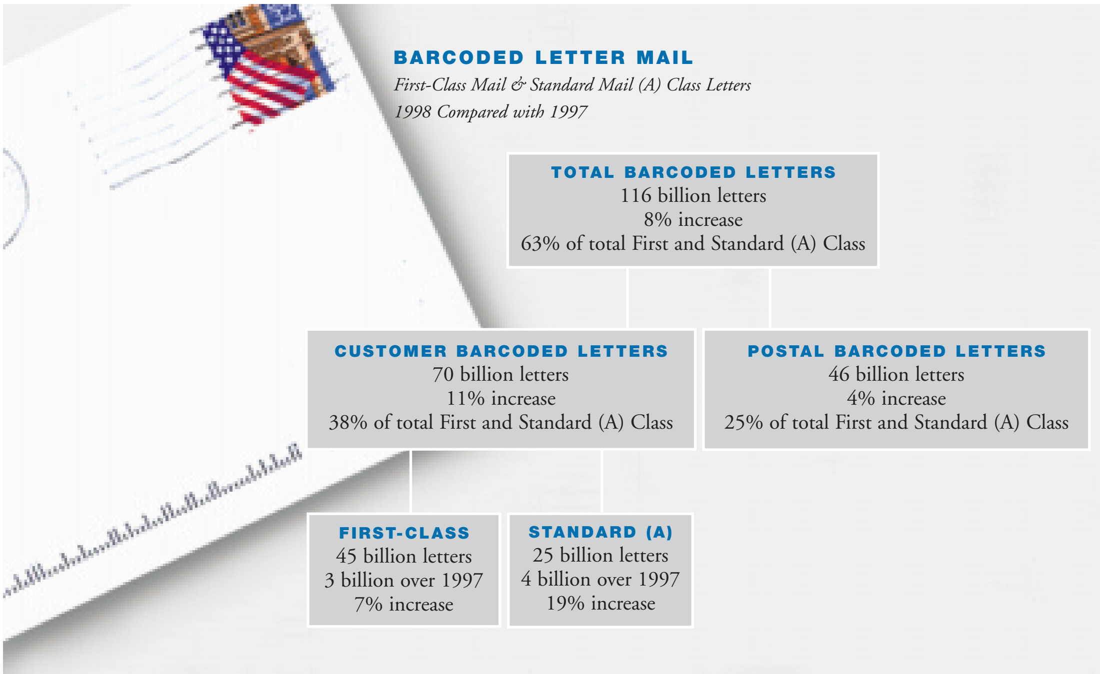
CUSTOMERPERFECT!

Three years ago, we conducted our first assessment based on the Malcolm Baldrige Award criteria. As a result of that assessment, we created the management system we call *CustomerPerfect!*, which focuses on our customers' needs and how we can better meet those needs. The approaches being taken through *CustomerPerfect!* are weaving their way through the fabric of the Postal Service and the way we do business. Our customer focus is becoming real through an understanding of our processes and how these work together to provide our services and products.

This year, we reviewed and renewed our commitment to *CustomerPerfect!* by conducting another assessment based on Baldrige criteria. This assessment documented our progress since the last assessment and identified five key areas on which we will focus. Based on this new assessment, we will work to:

• improve communication and relationships with employees and the bargaining units that represent them;

In Ft. Worth, Texas, our experimental "green" building shows our commitment to cooperating with the environment.



Customers continued to barcode larger amounts of their mail, helping us to reduce costs, increase efficiency, and serve our customers better.

• define the human resource implications of our strategic business objectives and develop human resource plans accordingly;

• standardize our core processes across all operations, making sure to leverage those approaches that are most effective in helping us to meet our performance objectives;

• develop a strategy for identifying, collecting, and using comparative data with which to evaluate our performance; and

• affirm the identity of the Postal Service to ensure that there is no ambiguity of purpose or direction.

For each of these areas, we have assigned an officer of the Postal Service the responsibility for planning and implementing appropriate action. We expect to see further improvements in our performance in the coming years.

YEAR 2000 PREPARATIONS

The Year 2000 problem stems from the nearly universal computer programming practice since the advent of the computers of using two rather than four digits to designate the calendar year. As a result of this and related practices, dates in 1999 and beyond can lead to problems in computer operations date translations, which in turn can lead to errors in data, incorrect conclusions based on erroneous data, and possibly interruptions in automated services. Since we are so highly automated and dependent on computers in both mail processing and administrative systems, the Postal Service has assigned the highest priority to activities that address the Year 2000 problem. Though technical in origin, this is a business problem that touches on all aspects of not just internal operations but those of our key vendors and service providers as well. Commitment to the success of the Year 2000 remediation efforts begins with the Postmaster General and extends, through the senior officers, to those assigned to take action.

Corrective actions on hardware and software computer components generally involve four phases: assessment, remediation, testing, and implementation. To date, we have completed our assessments of major corporate systems applications, computing and mail processing equipment, and other computer-based components. Focusing first on those components which support the most critical business operations, we have determined which hardware and software components have known or potential Year 2000-related problems. Once the responsible business manager has certified the mission critical applications as ready for Year 2000, we require that an independent verification be conducted. As of September 15, 1998, we had completed the remediation phase of 106 of 153 mission critical systems. We expect to complete remediation and verification activities on mission critical applications by the end of June 1999.

Small Parcel and Bundle Sorters reduce repetitive lifting, lowering our employees' risk for injury.

We plan to conduct readiness testing across several critical business processes and their interfaces in 1999. Because failures may occur in spite of our best efforts, we are also developing contingency plans to ensure business continuity.

We are also actively assessing the Year 2000 readiness of our suppliers and the business partners who exchange information with us. In today's business environment, we deal successfully with isolated failures of suppliers and information exchange partners. However, the Year 2000 problem poses the threat of a simultaneous failure of a number of suppliers or partners that could negatively impact our operations. Beginning with suppliers and partners identified as critical to our operations, we will continue to perform assessments, evaluate our alternatives, and where indicated, develop contingency plans for business continuity.

To evaluate the readiness of the mail processing systems, we tested the automated mail processing equipment at a major mail processing plant in Tampa and a bulk mail center in Atlanta. Both tests verified that our equipment will process letters, flats and parcels correctly to and through the Year 2000. Our ability to deliver mail could be disrupted by the failure of our transportation partners. For example, airlines route planes using computers, and we rely on their systems for almost 15,000 flights daily. Should the airlines fail, we could move the mail using alternative means of transportation, but it would take additional time. Finally, our ability to deliver mail could be partially affected by problems in ancillary services like stamp sales, postal meter operations, or in our ability to conduct automated financial transactions. We have undertaken or are engaged in a broad range of activities to mitigate any impact in these areas. Considering all possible internal and external events that could occur, it is possible that sometime during the Year 2000 we could experience delays for some types of mail. We believe such events would be restricted to relatively small geographic areas and will be effectively dealt with utilizing the contingency plans we are developing.

We are complementing our experienced internal resources with dedicated support from leading Year 2000 service providers. The total cost of Year 2000 activities is being funded through operating cash flows and is expected to approach $500-600 million through September 2000. So far, we have spent approximately $94 million remediating systems for Year 2000 readiness and managing our overall Year 2000 efforts.

INFLATION

We are a labor intensive business with approximately 77 percent of our costs attributable to personnel compensation and benefits. Therefore, inflation, as reflected in rising labor wage rates, significantly affects our financial condition. We reached tentative agreements with two of the three unions whose contracts expired in November 1998 and are negotiating with the third union. We expect that the increased labor costs resulting from these contracts will be in line with the expected rate of inflation.

Analysis of Liquidity

Liquidity is the cash we have in the bank (the Postal Service Fund) and the amount of money we can borrow immediately if needed. By law, we can borrow money only after notifying and offering the debt to the Secretary of the Treasury. Because Treasury has exercised its right of first refusal in recent years, an important part of our liquidity management program is negotiating solutions to our financing needs with the Department of Treasury and its Federal Financing Bank, which has been our lender. We manage our cash so that we meet our obligations and use any excess to reduce our debt or earn interest to get the most from our money.

During 1998, cash receipts totaled approximately $60 billion, not including financing and the face value of money orders. Once again, we set a record for the amount we received in one day. On January 21, 1998, we took in over $543 million, and we collected over $500 million on seven other occasions. That's a lot of money to manage effectively, but managing it well can produce significant benefits for us and ultimately our customers. During the last six years we have conducted a very aggressive liquidity management program. We designed this program to ensure we have enough cash and borrowing ability to meet our daily needs and invest in capital improvements, while we minimize our cash on hand and our debt. Our capital investments are designed to increase our productivity and efficiency so we can lower our costs while providing better service.

MINIMIZING CASH AND REDUCING DEBT

Minimizing cash and debt to control interest expense and risk has been a challenge. In 1992, the Postal Service had $9.9 billion in debt outstanding, paid $765 million in interest expense on our debt, while cash and securities in the Postal Service Fund averaged $6 billion. By 1997, we reduced the debt outstanding to $5.9 billion and the average cash balance to $1.8 billion. We have used our liquidity management program to further reduce our cash on hand to an average of $287 million during 1998. On September 30, 1998, we had approximately $395 million cash and cash equivalents on hand. That is not a lot of cash considering that our payroll every two weeks is typically over $1.6 billion.

Over the past few years we have worked closely with our lender to put in place the tools we need to manage our cash more effectively. Successful debt management should be viewed as an ongoing multiyear journey rather than a final destination. Major milestones in this journey have included obtaining call options (1992), making decisions to minimize cash and debt (1993), negotiating floating rate debt that can be repaid quarterly without penalty (1994), obtaining revolving credit lines of $1 billion (1996), tripling our credit line facilities to $3 billion (1997), and obtaining notes that we can borrow against with short notice (1998). These new financing tools give us unprecedented flexibility in addition to reducing the time it takes to borrow to only two days. In the past, it often took more than a month to complete the same financing. With these tools finally in place last year, we were able to use them to manage our liquidity to achieve the best results.

Entering the fiscal year, we had restructured our debt portfolio so that $5.1 billion of our $5.9 billion in outstanding debt could be repaid without penalty in 1998. This restructuring allowed us to manage our daily liquidity aggressively, resulting in a near zero ending cash balance on 117 business days and an average of $287 million for the year compared with four days in 1997 and an average of $1.8 billion.

Over the years, we reduced cash and debt by focusing on cash flow forecasting and by increasing our ability to adjust debt. In late 1992, all of our $9.9 billion debt was fixed-rate and noncallable. On September 30, 1998, only 45 percent of our $6.4 billion debt was fixed-rate and noncallable, 9 percent was floating rate, and the remaining debt was against short-term credit lines. An important part of our liquidity management program is the short-term credit lines we negotiated in 1996. With these lines of credit we can reduce the cash we keep on hand to meet our liquidity needs. The Overnight Revolving Credit Facility allows us to borrow up to $300 million on the same day we request it. The Short-Term Revolving Credit Facility allows us to borrow up to $2.7 billion with two days' notification.

Using these lines of credit, we saved paying substantial interest on two long-term notes. The first note for $1.5 billion carried an interest rate of 7.367 percent, and the second note for $1.0 billion carried an interest rate of 7.615 percent. These notes were the last remaining from the November 1992 debt restructuring. On December 1, 1997, we refinanced both notes at the first opportunity to call them using a combination of our overnight revolving credit facility, which had an interest rate of 5.52 percent, and our short-term revolving credit facility and new floating rate note, each of which had a 5.34 percent interest rate.

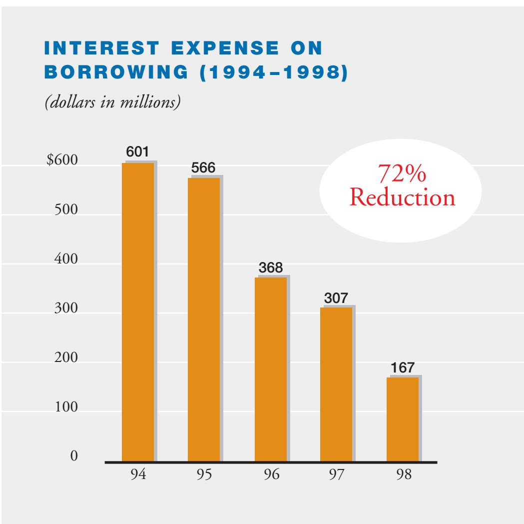
"We are at a critical crossroads in the history of the U.S. Postal Service. Over the past two years, Congress has taken major steps toward attempting to define our role as it relates to the interests of the public and private sectors. We are playing a leadership role in the process to create effective, productive reform."

Deborah K. Willhite
Senior Vice President,
Government Relations

Our strategy is to minimize our debt . . .

Successful debt management should include a strategic balance of both long- and short-term considerations. In 1998 we took advantage of declining long-term interest rates to lock in some very attractive financing that will serve to hold down interest expense in future years. In January 1998, we issued $1 billion of long-term debt at an average interest rate of 5.77 percent, our first long-term borrowing in over two years. In July, we issued $250 million more of long-term debt at an average of 5.62 percent, and in August we added an additional $500 million at 5.53 percent. Finally, in September we added $400 million at an average rate of 4.95 percent—the lowest long-term borrowing rate in Postal Service history and our first borrowing of any kind below 5 percent.

. . . and reduce our interest expense.



For 1998, our interest expense on borrowings was $167 million, which is a decrease of $140 million or 46 percent from 1997, and a $434 million decrease from our 1994 financing expense of $601 million. That is a 72 percent decrease in financing expenses in just four years. Since 1994, we have reduced debt 29 percent, from $9 billion to $6.4 billion on September 30, 1998. The weighted average rate of interest on long-term debt decreased from 7.35 percent in 1997 to 5.89 percent in 1998. Meanwhile, the average years to maturity for the debt expanded to 13.45 years from 6.76 years at the end of 1997. However, as we cautioned last year, our cash flow from operating activities declined during 1998 while our capital cash outlays remained in excess of $3 billion, resulting in an increase in our outstanding debt at the end of 1998 of $549 million. Yet while our outstanding debt increased, our interest expenses decreased due to a combination of reducing the interest rate on our debt and managing our debt to lower levels throughout the year.

While we anticipate that our operating activities in 1999 will continue to provide us with sufficient cash flow to cover expected obligations, they should also result in an increase in our debt outstanding similar to the increase in 1998.

AWARD WINNING CASH MANAGEMENT

Our liquidity management program has been very successful and has earned national recognition. In fact, *Treasury & Risk Management* magazine awarded us their 1998 Gold Alexander Hamilton Award for Cash Management and the Bronze Award for Excellence in Corporate Finance.

The Postal Service received the award in Corporate Finance for our liquidity management program of improving the balance sheet and income statement by reducing cash, debt, interest expense and risk. We were able to change the environment in which we operated in order to achieve the flexibility needed to manage our balance sheet. We were able to make changes both internally through increased awareness of debt management and emphasis of strong financial performance and externally through negotiated solutions to our business needs. The successful results of our program were discussed in the preceding section.

We received the Gold Alexander Hamilton Award for Cash Management for implementing innovative solutions to managing electronic

Treasury & Risk Management magazine awarded us their 1998 Gold Alexander Hamilton Award for Cash Management and the Bronze Award for Excellence in Corporate Finance.

payments from customers. To meet customer demand for more convenient payment options, we completed one of the largest roll-outs of debit/credit cards acceptance in history involving four major credit cards and all on-line debit card networks. This program included training 100,000 personnel and installing over 60,000 terminals at 33,000 locations. The Postal Service is also promoting the use of electronic payments from our business customers through the use of Automated Clearing House transfers and Fed Wire payments. Designing, implementing, and managing such large and complex electronic payment systems was a daunting challenge. To manage this task, we created a new group within Corporate Treasury in 1997.

We also created a cross-functional team that first pulled together the diverse postal management units involved in the project and then worked to develop a set of common cohesive management strategies and policies for electronic payment technologies that made the system run smoothly.

In addition to meeting our customers' needs with an award winning system, electronic payments save us money. Our studies show that processing electronic payments is much less expensive than handling cash or checks. We expanded the dollar amount of the payments we receive electronically from 11 percent of total cash receipts in 1997 to 15 percent during 1998. And we continue to pursue new payment options for all customers.

RELATIONSHIP BANKING

During the past year we continued our program to streamline and strengthen our bank relationships. By consolidating and competitively bidding our accounts we not only obtain better service and rates from banks, but we also improve financial controls, minimize our costs, and leverage our position as a major corporate customer.

Through September 1998 we signed 29 contracts providing banking services for post offices in 42 states with an estimated two-year savings of $20 to $25 million. In October 1998 we signed contracts covering an additional three states and plan to complete the process. Since we began our relationship banking program, we have reduced the number of banks with which we do business from over 5,000 to fewer than 100, of which 27 are major relationship banks which handle most of our business. We select banks that offer experience, innovation and superior technology and deal with us as they do with their other large business customers.

We have also continued our Minority Bank Certificate of Deposit Program with 69 participants. We began this program in 1996 to demonstrate our support for both the U.S. Treasury's Minority Bank Deposit Program and the minority bank community. Minority banks must meet select qualification criteria to participate in our program, which allows us to place $100,000 certificates of deposit in qualified institutions. We will continue to monitor eligibility standards for financial control purposes and to increase enrollment in the program.

During the year we engineered a seamless shift of our payroll disbursement account from the U.S. Treasury to four commercial banks. This major undertaking involved extensive coordination with many internal functional areas as well as external coordination with our relationship banks. The change has given us better financial controls, improved cash management and cost savings. Our employees also benefit from reduced inquiry time and faster processing of lost checks. Approximately 375,000 postal employee paychecks are drawn on these banks. This change did not affect the remaining 400,000 postal employees who have direct deposit of their paychecks.

$200 million every business day

During 1998 we took in more than $200 million every business day, and on eight of those days, we took in more than $500 million, with a record $554 million in one day.

Analysis of Capital

The Capital Budget has seen dramatic changes during the last decade. During the early seventies our capital plans did not exceed $1 billion. However, during the eighties and nineties our capital budget plans have increased significantly as we have aggressively pursued innovative and prudent investments. Our capital plans are designed to give us the tools we need to meet the challenges of improving mail service, maintaining a positive net income, ensuring good working conditions for our employees, providing positive customer relations, increasing management effectiveness, and reducing our operating costs by using the latest technology.

Our present five-year Capital Investment Plan is the result of thorough planning at all management levels. The individual projects in the plan are intended to support one or more of our *CustomerPerfect!* goals or strategic objectives. Although the Capital Investment Plan supports our basic mission of providing universal mail service to all of our customers, each project within the plan is subjected to a rigorous review, validation, and approval process designed to ensure the project is justified.

43 million

Every year we process 43 million address changes.

The timing of the relationship between the Capital Investment Plan, the financing plan, and balance sheet recognition is important. The commitments we identify in the Capital Investment Plan represent expected contract awards or options. We do not generally pay until the goods are delivered or a contractor meets its progress schedule. It is important to note that this entire process—from project approval, contract award, cash payments, capitalization, to any expected return on investment—can take a long time.

REVIEW OF CAPITAL INVESTMENTS

We subject all projects in the approved Plan to an intense review and approval process that ensures they are fiscally sound or service oriented. We establish accountability for the results we expect the project to produce. During the implementation of the project, we measure the project's operating and financial goals. Finally, when the project is completed, we may conduct an after-cost study and Inspection Service audit. All projects within the purview of the Capital Investment Committee follow this four step process.

1998 CAPITAL INVESTMENT PLAN

This is the third consecutive year that we have had record level capital commitments of over $3 billion. During 1998, the Board approved a total of $2.3 billion for 27 major capital investment projects, consisting of 11 facility projects, 14 equipment projects and 2 vehicle projects. We made commitments for the majority of these projects. And we expect to continue this high level of planned commitments for the next several years.

Almost 50 percent of our 1998 commitments, $1.8 billion, was attributable to building or improving facilities. The facility investments mainly satisfy capacity requirements because of the growth in population, mail volume, and delivery points. There is also an inventory of aging facilities that require repair or replacement. Properly maintaining our existing assets extends their useful lives, provides a business-friendly environment for our customers, and enhances working conditions for our employees.

We committed $1.2 billion for such labor-saving mail processing equipment as Advanced Facer Canceller Systems and Flat Sorting Machines 1000 Bar Code Readers.

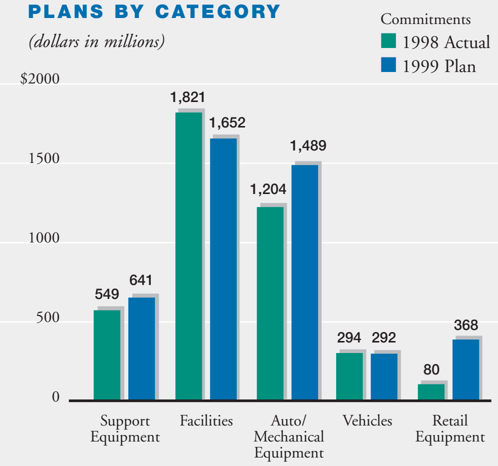
Vehicle commitments of $294 million continued to sustain our five-year vehicle strategic plan to deploy trailers and delivery and collection vehicles. Retail commitments consisted mostly of service-related equipment to support our retail infrastructure.

1999 CAPITAL INVESTMENT PLAN

Postal Service bylaws require that the Board of Governors approve the capital budget each year.

COMPARISON OF CAPITAL PLANS BY CATEGORY

(dollars in millions)

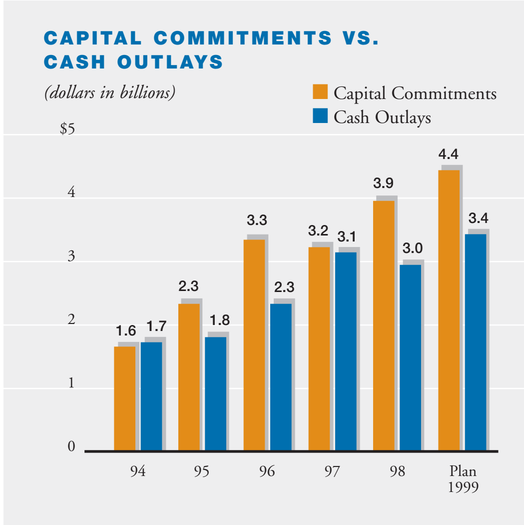


This process usually occurs between August and October. At its September 1998 meeting, the Board of Governors approved a 1999 Capital Investment Plan of $4.4 billion for 1999 and confirmed our $17 billion plan through 2002. The Capital Investment Plan is a five-year investment cycle for 1998–2002. The first year represents the budget year while the remaining four years represent a plan that will be reviewed by senior executives and the Capital Strategic Planning Committee. Normally, the Board of Governors would approve a five-year plan, but this year we recommended keeping the current $17 billion plan for five years and adjusting out year allocations. Only the Capital Investment Plan for 1999 was approved by the Board of Governors. To reduce borrowing, we will use internally generated funds as much as possible.

Projects for 1999 include such carryover projects from 1998 as Delivery Confirmation, asbestos removal, and projects with special funding. These projects are designed to meet the demands of the growth in our workload, repairing and replacing our aging infrastructure, and making use of the latest technology.

The facility component is the single largest component at $1.7 billion. For field projects of less than $5 million each, we have planned a total of $1 billion. This includes funding for over 300 projects for expansion and new construction of small facilities and funding for over 1,600 repair and alteration projects. There is $417 million projected for commitments for 25 major processing facilities. Funds have been included to modernize the 25-year-old facility housing Headquarters. Major systems are in need of upgrading or replacement such as lighting, air handling, electrical and communications. We will continue our Bulk Mail Center (BMC) Expansion program that allows the BMC network to handle in an efficient and more timely manner future growth in the volume of pallets and large parcels.

At $1.5 billion the equipment budget is the second largest portion of planned capital spending. This budget includes $899 million for material handling projects that will automate the transportation and preparation of mail trays, $307 million to upgrade currently installed Delivery Bar Code Sorters and $221 million to improve the Small Parcel Bundle Sorter Feed System, install the new Smart Delivery Unit and upgrade the existing



Flat Sorting Machines 1000 series with the Flat Sorting Machine 1000 Optical Character Reader.

We also plan to invest $518 million in such infrastructure projects as centralized telecommunications, automatic data processing and support for new computer applications.

We will commit $509 million to such Special Projects as Stage 2 of the deployment of our point of service or POS ONE System, construction of our International Service Centers to improve service for international and military mail, expanding our delivery confirmation capabilities and expanding our Corporate Call Management system.

Finally, we will spend $292 million to replace and upgrade our vehicle fleet, as well as $70 million to improve our retail services with new vending machines and customer support services.

All of the projects in our 1999 Capital Investment Plan are designed to promote one or more of our three basic goals: improve service to our customers, produce an economic return through cost savings, and improve working conditions and infrastructure.

While making capital investments to achieve these goals is important, we realize also that we are a part of the communities in which we work and which we serve. When we build a new building or rehabilitate an older one, we can affect the life of the community where we make that investment. So we try whenever possible to work with the local community so that we can help each other. The following projects are examples of our efforts to work with local communities even as we work to build a better Postal Service.

In cooperation with local government, we are renovating the historic Church Street Station in New York City.

Space in New York City is scarce and expensive, so when we decided to renovate the Church Street Station in lower Manhattan, we looked for ways to use the building that were economically sound yet still served the community. Located adjacent to the Civic Center and World Trade districts, Church Street Station is a 1 million square foot post office and former federal office building listed on the National Register of Historic Places. Built in 1938, this limestone art deco building housed a post office and federal office tenants for 60 years. With the construction of a new federal building, we had the opportunity to renovate the building into a state-of-the-art office building and postal facility. The building offers the quality of space and layout normally found only in modern buildings but which most of the older buildings in this area lack. Two public service agencies have taken long-term leases on all vacant space in the building. The Legal Aid Society of New York, the public defender for the City of New York, moved into 150,000 square feet of renovated space in July 1997, while the New York City Housing Authority has signed a lease for 450,000 square feet and will move in during late 1999. The renovation of the building includes improved public access and restoration of significant historic building elements such as the public lobby fronting on Church Street. In addition, by 2002 we will completely renovate and upgrade the rest of the building to improve working conditions for our employees.

15 billion handwritten addresses

Our clerks or our new technology read your handwriting, no matter how "creative" it might be.

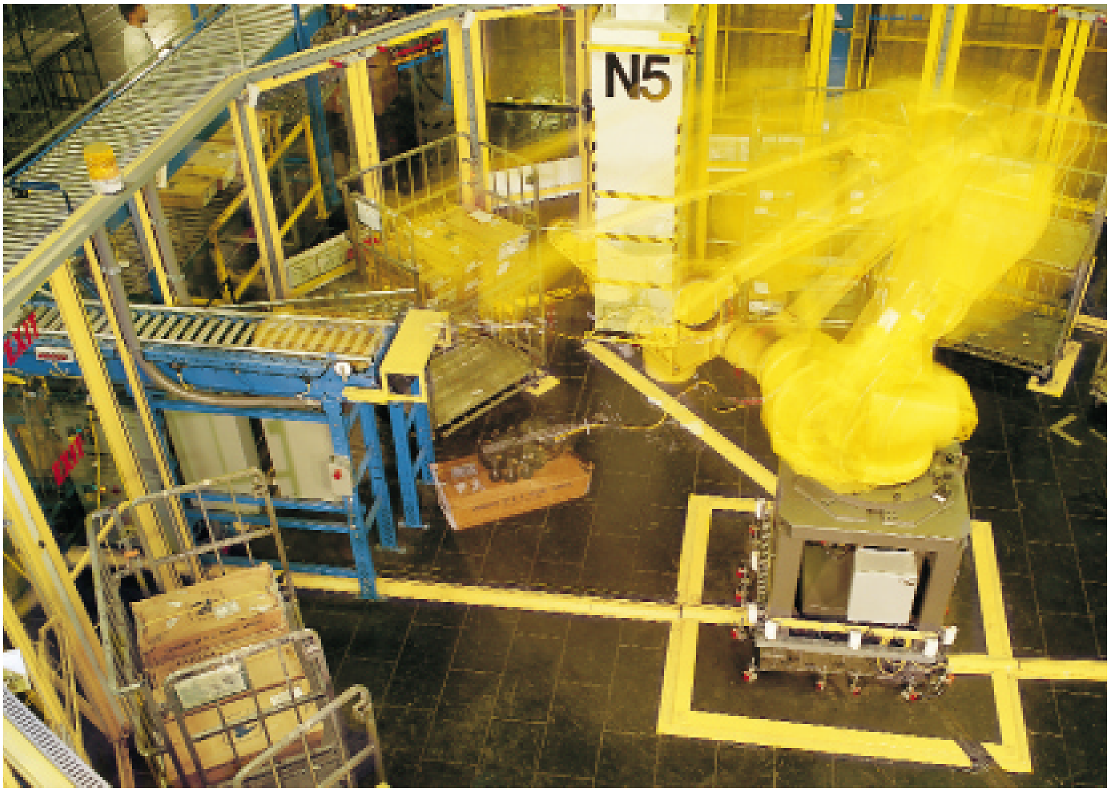
The Brooklyn General Post Office is a historic Romanesque structure constructed in 1885 and expanded in 1933. Originally built as a post office and federal courthouse, the courts and most of the postal operations moved to other locations over the years. With the need for a larger courthouse and the need for a postal facility in this location, we are working with the General Services Administration (GSA) to plan a two-building courthouse complex incorporating the existing federal courthouse site and the General Post Office. We hope to sell the General Post Office to the GSA while retaining a lease on 82,000 square feet of the renovated building. Plans call for the GSA to renovate the entire building, restoring public areas to their 1885 grandeur, including reinstating a four-story glass atrium lobby. Our space would include upgraded building systems, public accessibility, contemporary retail finishes and improved employee working conditions.

In Ft. Worth, Texas, we recently granted an easement that will enable the use of the historic Texas and Pacific railroad station as part of the new light rail commuter line. This station will not only serve as an important terminal for the new commuter line, it will also be restored to its original grandeur and will function as a center of the revitalization of this area of Ft. Worth. We are also reconstructing the post office in this area as part of the revitalization efforts. And in Seattle, Washington, we have offered to sell a now unused postal facility to the local school district so that they can consolidate 20 scattered offices around the city into a centralized location. Local school officials estimate that this arrangement could save the district over $30 million in acquisition costs.

TURNING RESEARCH AND DEVELOPMENT INTO REALITY

As a general policy, we do not conduct research and development in the same way that other companies do. Normally, our suppliers conduct the necessary research and development of new products, and we test what they have developed. Most of what we call research and development consists of testing the new products and technologies, as well as any modifications to existing products and technology, that our suppliers have developed. However, we do conduct research and development in the field of optical character recognition simply because this technology is so essential for us, and we are the leader in the field.

Our Remote Barcoding System is specifically designed to barcode mail that is not already barcoded and which existing Optical Character Reading equipment cannot barcode. Multiline



Pedestal-style robots automate the sorting and loading of mail trays.

Optical Character Readers and Facer Cancelers provide video images of letter mail addresses. These images are first processed by a Remote Computer Reader which attempts to electronically read the image and determine the proper barcode for the delivery point. If the Remote Computer Reader cannot read the address, it transmits the address to a Remote Encoding Center where a worker keys the address by hand.

For years, we have worked to improve the technology we use to recognize handwritten addresses. While the technology we use to electronically read typed or printed addresses has been very successful, we have had only limited success in recognizing handwritten addresses because there is such variation in styles of handwriting. Less than three years ago, Remote Computer Readers (RCR) could fully resolve only 2 percent of the handwritten mail they received. We have improved this technology so that today the RCR can barcode 25 percent of the hand-addressed images it receives.

HANDWRITING RECOGNITION SOFTWARE

In 1998, we awarded a contract for new software that is designed to increase to 50 percent the rate at which the RCR can read and resolve handwritten addresses. Our goal is to have the new software developed by June 1999 so that it can be deployed to the 254 RCRs we have in place. This new technology reduces the amount of time workers spend keying information by hand at our Remote Encoding Centers. In addition, with improved recognition by the Remote Computer Reader, we can barcode and process more mail faster, resulting in improved service to our customers.

Our automated systems process address changes for the 17 percent of the nation's population that moves each year.

"The Postal Service is committed to providing our customers with real-time information about their mail. This same information, some of which already exists in the mail stream and some of which must be created, when combined with activity-based cost data, will be used to improve services and cost performance for our customers."

Norman E. Lorentz
Senior Vice President and
Chief Technology Officer

NEW IDENTIFICATION CODE SORTING PROGRAM

This year we completed the research and development for two extremely important advances in mail processing technology, and we will begin deploying this new technology in 1999. The first program will upgrade our letter mail automation system so that we will have the ability to sort and track mail. The second program will use the data from this upgraded system to provide valuable management information.

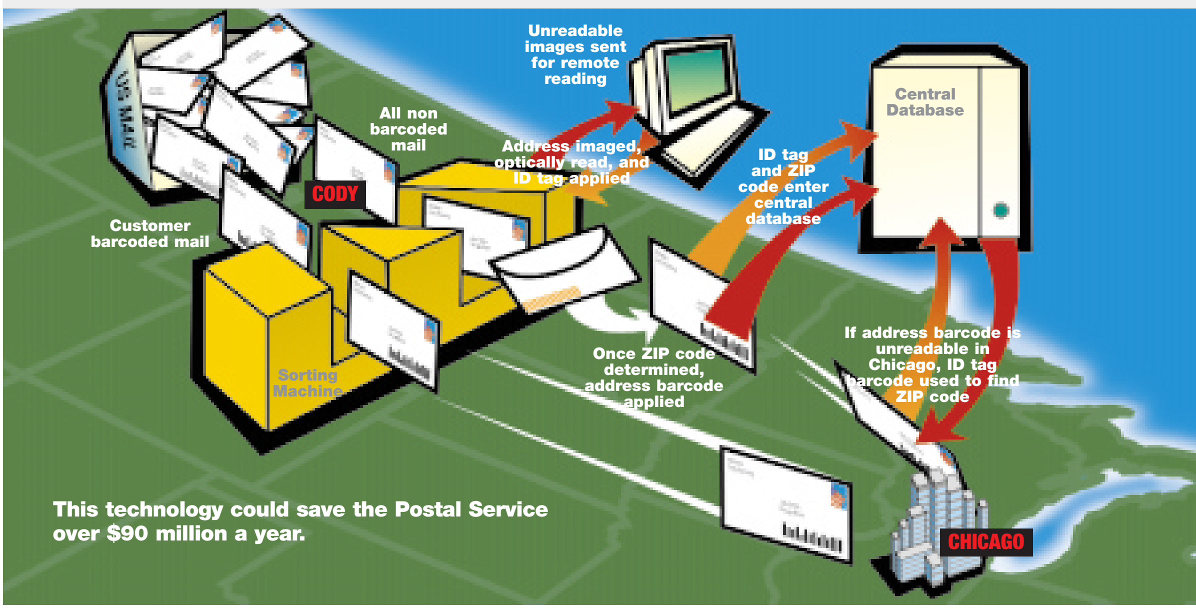
Did you notice the fluorescent barcode on the back of the letters you receive? We use that fluorescent barcode as an identification tag to keep track of the letter while we are trying to determine where it is going. If our machines can read the address or the barcode already on the letter, we can send it on its way in seconds. If our machines cannot immediately read the address or barcode, or the barcode is incorrect, the letter is temporarily staged for further processing. Then either our Remote Computer Readers (RCR) or a Remote Encoding (RC) operator views a video image of the address and applies the correct barcode. Then we use that fluorescent identification barcode to retrieve the letter from the staging area, apply the address barcode and send it on its way.

Our new Identification Code Sorting (ICS) program sends the identification barcode to a computer. After the RCR or RC operator reads the address, the correct address is sent to the computer so all it has to do is simply look up the correct barcode. In addition, every time we process that letter we update the computer so the computer knows the location of that letter in the mail system. This saves us from having to manually process over 800 million pieces of mail. For example, when you mail a letter in Cody, Wyoming, bound for Chicago, we put a fluorescent identification barcode on the back of the letter and tell the computer the Chicago address. If our machines in Chicago cannot read the address barcode when the letter gets to Chicago, they can simply look up the identification barcode and keep it moving. Right now we cannot read about 6 percent of the address barcodes on the mail, so this increase in efficiency directly improves our customer service. Second, we will no longer have to label and re-barcode over 1.6 billion pieces of mail. This will save us over $90 million annually.

NATIONAL SERVICE CENTERS

In order to serve our customers better, we are investing in a network of National Service Centers. We opened our second Center in 1998. Located in Kansas City, the Center will serve customers in a 13-state area. When completed, we will have a network of six fully integrated Centers that offer customers easy access to our services and products 24 hours a day, seven days a week via a single toll-free number. The centers are staffed with trained personnel who can answer the approximately 200 million telephone calls that are currently handled by local post offices. These centers offer our customers quick and easy access to the information they need to make better use of all the services we offer.

CODY, WY TO CHICAGO—HOW OUR NEW AUTOMATED SYSTEM WILL WORK



Statements of Operations

(dollars in millions)

	Years ended September 30, 1998	1997	1996
Operating revenue—Note 8	$60,072	$58,216	$56,402
Operating expenses:			
Compensation and benefits—Notes 2, 6, and 7	45,588	43,835	42,676
Transportation	4,207	4,026	3,736
Other	7,983	7,012	6,701
Total operating expenses	57,778	54,873	53,113
Income from operations	2,294	3,343	3,289
POD workers' compensation expense—Note 3	(8)	(258)	-
Interest and investment income	44	115	142
Interest expense on deferred retirement liabilities—Note 6	(1,597)	(1,597)	(1,449)
Interest expense on borrowings	(167)	(307)	(368)
Imputed interest on OBRA 1993 retroactive assessments for employee benefits—Note 4	(16)	(32)	(47)
Net income	$ 550	$ 1,264	$ 1,567

See accompanying notes to financial statements.

Balance Sheets

(dollars in millions)

	September 30, 1998	September 30, 1997
Assets		
Current assets:		
Cash and cash equivalents	$ 395	$ 403
Receivables:		
Foreign countries	514	441
U.S. Government	154	101
Consignment	51	48
Other	154	159
	873	749
Less allowances	88	77
Total receivables, net	785	672
Supplies, advances and prepayments	348	388
Total current assets	1,528	1,463
Other assets, principally revenue forgone appropriations receivable—Note 8	379	372
Property and equipment, at cost:		
Buildings	15,123	13,911
Equipment	11,179	10,328
Land	2,286	2,178
Leasehold improvements	916	797
	29,504	27,214
Less allowances for depreciation and amortization	10,785	9,702
	18,719	17,512
Construction in progress	2,073	1,862
Total property and equipment, net	20,792	19,374
Deferred retirement costs—Note 6	31,844	31,929
Total assets	$54,543	$53,138

See accompanying notes to financial statements.

	September 30, 1998	1997
Liabilities and Net Capital Deficiency		
Current liabilities:		
Compensation and benefits	$ 5,290	$ 5,056
Estimated prepaid postage	1,673	1,743
Payables and accrued expenses:		
Foreign countries	780	703
U.S. Government	148	181
Other	742	940
Total payables and accrued expenses	1,670	1,824
Prepaid box rentals, permit and metered mail	1,955	1,924
Outstanding postal money orders	692	640
Current portion of long-term debt	3,633	2,647
Total current liabilities	14,913	13,834
Long-term debt, less current portion—Note 5	2,788	3,225
Other liabilities:		
Amounts payable for deferred retirement benefits—Note 6	30,138	30,343
Workers' compensation costs—Note 2	4,923	4,749
Employees' accumulated leave	1,959	1,858
Other	632	489
Total other liabilities	37,652	37,439
Commitments and contingencies—Notes 9 and 11		
Total liabilities	55,353	54,498
Net capital deficiency:		
Capital contributions of the U.S. Government	3,034	3,034
Deficit since reorganization	(3,844)	(4,394)
Total net capital deficiency	(810)	(1,360)
Total liabilities and net capital deficiency	$54,543	$53,138

See accompanying notes to financial statements.

Statements of Changes in Net Capital Deficiency

(dollars in millions)

	Years ended September 30, 1998, 1997, and 1996		
	Capital Contributions of U.S. Government	Deficit Since Reorganization	Total Net Capital Deficiency
Balance, September 30, 1995	$3,034	$ (7,225)	$ (4,191)
Net Income	-	1,567	1,567
Balance, September 30, 1996	3,034	(5,658)	(2,624)
Net Income	-	1,264	1,264
Balance, September 30, 1997	3,034	(4,394)	(1,360)
Net Income	-	550	550
Balance, September 30, 1998	$3,034	$(3,844)	$ (810)

See accompanying notes to financial statements.

Statements of Cash Flows

(dollars in millions)

	Years ended September 30,		
	1998	1997	1996
Cash flows from operating activities:			
Net income	$ 550	$ 1,264	$ 1,567
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	1,579	1,673	1,333
Loss on disposals of property and equipment, net	7	19	15
Increase in other assets, principally revenue forgone appropriations receivable	(7)	(18)	(37)
Increase (decrease) in USPS workers' compensation	195	(332)	205
(Decrease) increase in Post Office Department workers' compensation	(27)	258	-
Decrease in retroactive assessments payable to the U.S. Government	(331)	(315)	(300)
Increase in employees' accumulated leave	101	236	67
Increase in other liabilities	143	46	100
Changes in current assets and liabilities:			
(Increase) decrease in receivables, net	(113)	55	151
Decrease (increase) in supplies, advances and prepayments	40	22	(31)
Increase (decrease) in compensation and benefits	451	128	(562)
(Decrease) increase in estimated prepaid postage	(70)	20	26
Decrease in payables and accrued expenses	(154)	(1)	(190)
Increase in prepaid box rentals, permit and metered mail	31	332	162
Increase (decrease) in outstanding postal money orders	52	(40)	(17)
Net cash provided by operating activities	2,447	3,347	2,489
Cash flows from investing activities:			
Purchase of U.S. Government securities, available-for-sale	(620)	(300)	(799)
Proceeds from sale of U.S. Government securities, available-for-sale	622	300	800
Purchase of property and equipment	(3,055)	(3,233)	(2,340)
Proceeds from sale of property and equipment	49	26	4
Net cash used in investing activities	(3,004)	(3,207)	(2,335)
Cash flows from financing activities:			
Issuance of debt	5,696	1,964	1,500
Payments on debt	(5,147)	(2,011)	(2,861)
Net cash provided by (used in) financing activities	549	(47)	(1,361)
Net (decrease) increase in cash and cash equivalents	(8)	93	(1,207)
Cash and cash equivalents at beginning of year	403	310	1,517
Cash and cash equivalents at end of year	$ 395	$ 403	$ 310

See accompanying notes to financial statements.

Notes to the Financial Statements

1. Description of Business

Nature of Operations

The United States Postal Service (Postal Service) provides mail service to the public, offering a variety of classes of mail services without discrimination among its many customers. This means that within each class of mail our price does not vary by customer for the levels of service we provide. This fulfills our legal mandate to offer universal services at a fair price. Our primary lines of business are First-Class Mail, Standard Mail (A) and Priority Mail. The principal markets for these services are the communications, distribution and delivery, advertising and retail markets. Our products are distributed through our more than 38,000 post offices and a large network of consignees. As in the past, we continue to conduct our significant operations primarily in the domestic market, with our international operations representing less than 3 percent of our total revenue. Our labor force is primarily represented by the American Postal Workers Union, National Association of Letter Carriers, National Postal Mail Handlers Union and National Rural Letter Carriers Association. Almost 90 percent of our career employees are covered by collective bargaining agreements. No agreement expired in fiscal year 1998. However, three of our largest contracts representing 82 percent of our career employees expire November 20, 1998.

$60.1 billion

Our 1998 total operating revenue was $60.1 billion.

Postal Reorganization

The Postal Service commenced operations on July 1, 1971, in accordance with the provisions of the Postal Reorganization Act (the Act). The equity that the U.S. Government held in the former Post Office Department became the initial capital of the Postal Service. The Postal Service valued the assets of the former Post Office Department at original cost less accumulated depreciation. The U.S. Government remained responsible for all the liabilities attributable to operations of the former Post Office Department.

The Balanced Budget Act of 1997 charged the Postal Service with certain liabilities attributable to operations of the former Post Office Department for the first time since postal reorganization. Our 1997 financial statements contained a $258 million reduction to net income as a result, with an additional $8 million expense in 1998 (Note 3).

Price Setting Process

Since 1971, the Act has required the Postal Service to establish prices that cover the costs of operating the postal system. The Act established the independent Postal Rate Commission with oversight responsibility for mail prices, subject to approval by the Governors of the Postal Service. The Act provides for the recovery of operating losses through future rate increases.

2. Summary of Significant Accounting Policies

Basis of Accounting and Use of Estimates

The Postal Service maintains its accounting records and prepares its financial statements on the accrual basis of accounting. This basis conforms with generally accepted accounting principles. Following these principles, we made estimates and assumptions that affect the amounts we report in the financial statements and notes. Actual results may differ from our estimates.

Cash Equivalents

Cash equivalents are securities which mature within 90 days or less from the date we buy them.

Current Values of Financial Instruments

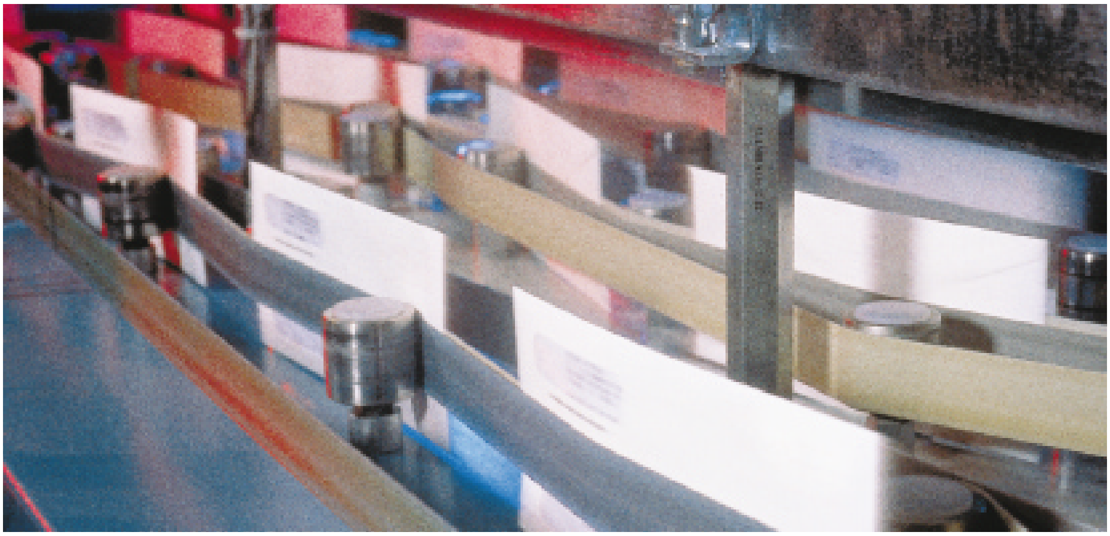
We determine the current value of our investments in non-marketable U.S. Government securities based on the current value of equivalent marketable U.S. Government securities. We determine the current value of our debt based on what we estimate it would cost us to pay off the debt if we used the current yield on equivalent U.S. Treasury debt.

Supplies, Advances & Prepayments

Supplies, advances and prepayments are primarily composed of our inventories of supplies, motor vehicle parts, repairable parts for mail processing equipment and advances to employees for annual leave. We value our inventories at the lower of average cost or current market price. Total inventories amounted to $158 million at the end of 1998 and $187 million at the end of 1997.

Property and Equipment

We record property and equipment at what it cost us to acquire the assets, including the interest we



Our plants use highly efficient equipment to speed your letter on its way.

pay on the money we borrow to pay for the construction of major capital additions. This interest amounted to $44 million in 1998, $22 million in 1997 and $29 million in 1996.

We depreciate buildings and equipment over their estimated useful lives, which range from 3 to 40 years, using the straight-line method. We amortize leasehold improvements over the period of the lease or the useful life of the improvement, whichever time is shorter.

During 1997 we changed our policy for expensing minor asset purchases. We increased the limit from $2,000 to $3,000. As a result, we expensed $83 million of assets in 1997 that were under the new limit.

Estimated Prepaid Postage

This is the amount of cash we estimate that we collected by the end of the year for services that we will perform in the following year.

Compensation and Benefits Payable

This is the salaries and benefits we owe to current and retired employees, including the amounts employees have earned but have not yet been paid, current workers' compensation, unemployment costs, health benefits and the current portion of the amounts payable for retirement benefits.

Deferred Retirement Benefits

This is the present value of our estimated legal obligation to the Civil Service Retirement and Disability Fund for the amount of retirement benefits payable in the future for our current employees' retirement and our present retirees and their survivors. The present value of our benefits payable for our current employees increases when management increases basic pay. The present value of our benefits payable also increases when Cost of Living Adjustments (COLAs) are granted to our retirees or their survivors. We capitalize as deferred retirement costs the amounts due and payable in future years. We expense and pay these costs over periods of 30 years for amounts attributable to current employees and 15 years for amounts attributable to retirees, at 5 percent interest. We account for our participation in the U.S. Government sponsored retirement plans as participation in a multi-employer plan arrangement.

Post-Retirement Health Benefits

Retiree health benefits costs are our obligation to pay a portion of the health insurance premiums of those retirees and their survivors who participate in the Federal Employees Health Benefits Program (FEHBP). We account for our participation in FEHBP as participation in a multi-employer plan arrangement. Therefore, we expense the costs of our retiree health benefits as we incur them.

Workers' Compensation Costs

We are self-insured for workers' compensation costs under a program administered by the Department of Labor (DOL). We record these costs, which include the employees' medical expenses and payment for continuation of wages, as an operating expense. At the end of the year, our liability represents our estimated present value of the total amounts we expect to pay for outstanding claims. We base our estimate of the total costs of a claim upon the severity of the injury, the age of the injured employee, the assumed life expectancy of the employee, the trend of our experience with such an injury and other factors.

In our calculation of present value, we use a net discount rate of 0.1 percent for medical expenses and 3.0 percent for compensation claims.

In 1996, we changed one of the assumptions we use to estimate our workers' compensation liability. As part of our calculation, we use the trends in our claims for the current year and the claims from previous years to estimate the length of time an employee will receive workers' compensation. Beginning in 1996 we placed greater emphasis on our experience with prior years' claims to estimate this liability. As a result, we had an increase in expense of $113 million in 1996.

$3.1 billion

We spent $3.1 billion in 1998 on capital improvements to serve our customers better.

At the end of 1998, we estimate our total liability for future workers' compensation costs at $5,287 million, excluding Post Office Department (POD) liability (Note 3). At the end of 1997, this liability was $5,092 million. In 1998, we recorded $760 million in workers' compensation expense, compared to the $206 million we recorded in 1997 and the $737 million we recorded in 1996.

Research and Development Costs

We record research and development costs as expenses when we incur them. These costs were $77 million in 1998, $68 million in 1997 and $56 million in 1996.

Advertising

We record advertising costs as expenses when we incur them. These costs were $301 million in 1998, $266 million in 1997 and $236 million in 1996.

3. Balanced Budget Act of 1997

Under the Postal Reorganization Act of 1971, the U.S. Government remained responsible for payment of all Post Office Department (POD) workers' compensation claims incurred before June 30, 1971. This Act required that the newly-created USPS would be responsible only for its own workers' compensation claims. However, under the Balanced Budget Act of 1997, the remaining liability for these POD costs has now been transferred to the U.S. Postal Service. We estimate the present value of these claims was $258 million at the end of 1997. We recorded this amount as an expense for 1997. The 1998 expense is $8 million, and the estimated liability is $231 million. In our calculation we use a net discount rate of 3 percent.

4. Retroactive Assessments for Employee Benefits

Omnibus Budget Reconciliation Act of 1993

Under the Omnibus Budget Reconciliation Act of 1993, we must pay 5 percent interest on the $2.14 billion retroactive assessment from the Omnibus Budget Reconciliation Act of 1990. We paid this interest in three equal annual installments totaling $1.041 billion. We made the first payment in 1996 and the second in 1997 for a total of $694 million. We made the final payment this year of $347 million.

5. Debt and Related Interest Costs

Under the Postal Reorganization Act, as amended by Public Law 101-227, we can issue debt obligations. However, we are limited to net annual increases of $2 billion in our debt for capital improvements and to $1 billion for operating expenses. Our total debt cannot exceed $15 billion.

Debt is due as follows (dollars in millions):

Year	Amount
1999	$3,633
2000	84
2001	52
2002	201
2003	-
After 2003	2,451

We paid in cash $236 million in interest in 1998, $336 million in interest in 1997 and $473 million in 1996.

The current estimated market value of our debt is $6,639 million in 1998 and $6,102 million in 1997 (Note 2). All notes payable to the Federal Financing Bank (FFB) may be repurchased at current value at any time with five days notice of intent to do so.

The following page details our debt, which consists of notes payable to the FFB and mortgage notes payable:

OUR DEBT CONSISTS OF THE FOLLOWING

(dollars in millions)

Interest Rate %	Terms	September 30, 1998	1997
Notes Payable to the Federal Financing Bank (FFB):			
8.075	Payable $32 million each year to May 31, 2000	$ 64	$ 96
7.800	Payable $15 million each year to May 31, 2001	45	60
7.591	Payable $50 million each year to June 1, 1997 and $23 million due on June 1, 1998	-	23
8.474	Payable $30 million each year to June 1, 1998	-	30
8.908	Payable $35 million each year to June 1, 1998	-	35
9.074	Payable $60 million each year to June 1, 1998	-	60
8.761 *	Payable $24 million on June 2, 1997; payments of $36 million each year on June 1, 1998–1999; and payments of $36 million each year thereafter through May 31, 2001	108	144
7.786	Payable September 30, 1998	-	450
7.367	Payable August 15, 2002	-	1,500
7.615	Payable November 30, 2007	-	1,000
6.274	Payable May 16, 2005	500	500
4.491 **	Overnight revolving credit facility; final maturity date November 30, 1998	246	164
4.667	Payable November 15, 2026; repurchasable at par November 16, 1998 and every February 15, May 15, and August 15 thereafter	600	-
4.667 ***	Short-term revolving credit facility; final maturity date November 30, 1998	2,700	1,800
5.568	Payable December 31, 2002	200	-
5.688	Payable August 15, 2007	400	-
5.546	Payable August 15, 2007	150	-
5.959	Payable November 15, 2027	400	-
5.726	Payable November 15, 2027	100	-
5.606	Payable November 15, 2027	300	-
5.426	Payable May 15, 2008	200	-
4.981	Payable May 15, 2008	200	-
4.910	Payable May 15, 2008	200	-
		6,413	5,862
Mortgage Notes Payable:			
5.00 to 9.75	Maturing from fiscal years 1999 through 2039 secured by land, buildings and equipment with a carrying amount of $41 million. (Aggregate annualinstallments approximate $1 million)	8	10
		6,421	5,872
Less current portion of debt		3,633	2,647
		$2,788	$3,225

* Weighted average interest rate; prior year's weighted average interest rate was 8.764%

** Prior year rate was 5.312%.

*** Prior year rate was 5.198%.

6. Retirement Programs

With certain exceptions, employees participate in one of the following three retirement programs based upon the starting date of their employment with the Postal Service. Employee and employer contributions are made to the Civil Service Retirement and Disability Fund (CSRDF), which is administered by the Office of Personnel Management. Employees may also participate in the Thrift Savings Plan, which is a defined contribution retirement savings and investment plan. Postal Service employees are authorized to participate in the Thrift Savings Plan by the Federal Employees Retirement System Act of 1986. The Plan is administered by the Federal Retirement Thrift Investment Board.

Civil Service Retirement System (CSRS)

Under the Postal Reorganization Act, officers and career employees are covered by the Civil Service Retirement System, which provides a basic annuity and Medicare coverage. The CSRS fund covers substantially all employees hired prior to January 1, 1984. We and the participating employee each contribute 7 percent of the employee's basic pay to the CSRDF. We and the employee also contribute to Medicare at the rate prescribed by law. We do not match contributions to the Thrift Savings Plan for employees who participate in the CSRS.

Dual Civil Service Retirement System (Dual CSRS)/Social Security System

Employees with prior U.S. Government service who were hired between January 1, 1984 and January 1, 1987 are covered by the Dual Civil Service Retirement System/Social Security System. We contribute 7 percent of the employee's basic pay to the CSRDF. The employee contributes 0.8 percent of basic pay. We and the employee also contribute to Social Security and Medicare at the rates prescribed by law. We do not match contributions to the Thrift Savings Plan for employees who participate in the Dual System.

Federal Employees Retirement System (FERS)

Effective January 1, 1987, officers and career employees hired since December 31, 1983, except for those covered by the Dual System, are covered by the Federal Employees Retirement System Act of 1986. In addition, employees hired before January 1, 1984 could choose during certain periods in 1987 and 1988 to participate in the FERS. This System consists of Social Security, a basic annuity plan, and a Thrift Savings Plan.

We contributed to the basic annuity plan 10.7 percent of each employee's basic pay in 1998 and 11.4 percent in 1997 and 1996. Employees contributed 0.8 percent of their basic pay in these years. We and the employee also contribute to Social Security and Medicare at the rates prescribed by law. In addition, we are required to contribute to the Thrift Savings Plan a minimum of 1 percent per year of the basic pay of employees covered by this System. We also match a voluntary employee contribution up to 3 percent of the employee's basic pay, and 50 percent of a contribution between 3 percent and 5 percent of basic pay.

The number of employees enrolled in each of the retirement plans at the end of 1998, 1997 and 1996 is as follows:

	1998	1997	1996
CSRS	298,827	314,068	328,270
Dual CSRS/ Social Security	13,418	13,900	14,320
FERS	479,069	436,735	417,948

Deferred Retirement Costs

Deferred retirement costs consist of the following deferred liabilities (dollars in millions):

	1998	1997
CSRS basic pay increases	$25,827	$26,133
CSRS retirees' and survivors' cost of living adjustments	6,017	5,796
Total	$31,844	$31,929

There are no deferred retirement costs associated with FERS.

Deferred Retirement Liability—Civil Service Retirement System

When we increase our employees' current basic pay, we are liable for the additional deferred retirement liability. The liability results from the increase in our employees' retirement benefits which are based on this pay increase. The Office of Personnel Management determines the estimated increase in our deferred liability. We amortize and pay this amount in 30 equal annual installments, which includes interest computed at a rate of 5 percent per year. We make the first payment at the end of the year in which employees receive their pay increase.

The increase in our deferred liability for retirement benefits under the CSRS as a result of basic pay increases was $836 million in 1998, $560 million in 1997 and $3,696 million in 1996.

Deferred Retirement Liability—Retirees' and their Survivors' Cost of Living Adjustments (COLAs)

Congress determines the COLAs granted to our retirees. Under the Omnibus Budget Reconciliation Act of 1990, we are liable for our share of the cost of living adjustments granted to those retirees, and their survivors, retiring on or after July 1, 1971. We are not responsible for any costs due to Federal civilian service before that date.

Each year the Office of Personnel Management determines the estimated increase in our liability under this law for the current year. We amortize and pay each year's amount in 15 equal annual installments, which include interest computed at a rate of 5 percent per year.

The increase in our deferred liability for our retirees' COLAs was $790 million in 1998, $1,041 million in 1997 and $951 million in 1996.

Future Minimum Payments

We estimate the future minimum payments we have to make in order to fund CSRS benefits and retirees' cost of living adjustments as of September 30, 1998, are as follows (dollars in millions):

Year	Amount
1999	$ 3,301
2000	3,282
2001	3,274
2002	3,203
2003	3,124
After 2003	32,507
	$48,691
Less amount representing interest	16,834
Total future minimum payments	$31,857
Less: Portion classified as a current liability in compensation and benefits	1,719
Long-term portion of future minimum payments	$30,138

Expense Components

Listed below are the components of our total retirement expenses that are included in our compensation and benefits expense and related interest expense in the Statement of Operations for 1998, 1997 and 1996 (dollars in millions):

	1998	1997	1996
CSRS	$ 849	$ 870	$ 877
FERS	1,640	1,590	1,473
FERS—Thrift Savings Plan	608	552	489
Dual CSRS/Social Security	36	36	36
Social Security	1,241	1,162	1,082
Amortization of deferred cost:			
CSRS	1,142	1,064	1,157
Annuitant COLAs	569	552	507
Interest expense on deferred liabilities	1,597	1,597	1,449
Imputed interest on OBRA '93	16	32	47
Total retirement expense	$7,698	$7,455	$7,117

7. Post-Retirement Health Benefit Programs

Employees of the Postal Service who participate in the Federal Employees Health Benefits Program (FEHBP) for at least the five years immediately before their retirement may participate in the FEHBP during their retirement. Under the FEHBP, we pay a portion of the health insurance premiums of participating retirees and their survivors. This Program is administered by the Office of Personnel Management.

The Omnibus Budget Reconciliation Act of 1990 requires us to pay the employer's share of health insurance premiums for all employees, and their survivors, who participate in the FEHBP and who retire on or after July 1, 1971. However, we do not include the costs attributable to Federal civilian service before that date. Our FEHBP costs amounted to $581 million in 1998, $548 million in 1997 and $497 million in 1996. We include these costs in our compensation and benefits expense.

8. Revenue Forgone

Our operating revenue includes accruals for revenue forgone. Revenue is forgone when Congress mandates that we provide free or reduced mail rates for certain mailers. The difference between the price Congress has mandated and the price we would have charged the mailer determines the amount of forgone revenue. Congress appropriates money to reimburse us for only a portion of the revenue forgone that we have incurred in past years. In our operating revenue, we have included as revenue the amounts for revenue forgone of $67 million for 1998, $83 million for 1997 and $93 million for 1996. Legislation that was passed after our year ended appropriated $71 million for 1999 but delayed the payment until fiscal year 2000. Accordingly, we will record this as a receivable in 1999.

$1.6 billion

We typically pay $1.6 billion in salary and benefits every two weeks.

Under the Revenue Forgone Reform Act of 1993, Congress is required to reimburse us $29 million annually through 2035 (42 years). This reimbursement is for two purposes: services we performed in 1991, 1992 and 1993 for which we have not yet been paid; and for shortfalls in the reimbursement for the costs we incurred for processing and delivering certain nonprofit mail from 1994 through 1998. Legislation passed after our year end failed to appropriate the $29 million owed for FY 1999. We can only assume, based on subcommittee notes, that they do intend to pay us this amount but that the payment is delayed. Because of the uncertainty of the legislative intent we have recorded an allowance for the principal portion of this installment in our bad debt account. If Congress doesn't pay us, we can by law make up that lost income by adjusting our rates on all mailers through the postal rate making process.

The Revenue Forgone Reform Act of 1993 authorized a total of $1.218 billion in payments. We calculate the present value of these future reimbursements to be approximately $390 million at 7 percent interest. At the end of 1998, we have recognized cumulative revenues of approximately $390 million. The amounts receivable as of September 30, 1998 and 1997 were $380 million and $372 million, respectively. We recognized revenue of $10 million in 1998, $22 million in 1997 and $37 million in 1996.

9. Commitments

At September 30, 1998, we estimate our financial commitment for approved Postal Service capital projects in progress is $3.7 billion.

Our total rental expense for the years ended September 30 is summarized as follows (dollars in millions):

	1998	1997	1996
Noncancellable real estate leases including related taxes	$711	$659	$616
Facilities leased from General Services Administration subject to 120-day notice of cancellation	37	34	36
Equipment and other short-term rentals	234	154	153
Total	$982	$847	$805

At September 30, 1998, our future minimum lease payments for all non-cancelable leases are as follows (dollars in millions):

Year	Operating	Capital
1999	$ 681	$ 54
2000	637	54
2001	577	54
2002	524	54
2003	479	54
After 2003	4,772	255
	$7,670	525
Less: Interest at 6.5 percent		137
Total capital lease obligations		388
Less: Short-term portion of capital lease obligations		30
Long-term portion of capital lease obligations		$358

Most of these leases contain renewal options for periods ranging from 3 to 20 years. Certain noncancellable real estate leases give us the option to purchase the facilities at prices specified in the leases.

Capital leases included in buildings were $388 million in 1998 and $272 million in 1997. Total accumulated amortization is $86 million in 1998 and $54 million in 1997. Amortization expense for assets recorded under capital leases is included in depreciation expense.

10. Impaired Assets

In 1997, we began to record losses on long lived assets when events and circumstances indicate that the assets might be impaired. In accordance with FASB Statement No. 121, "Accounting for the Impairment of Long-lived Assets and for Long-lived Assets to Be Disposed Of," we have written down our impaired assets to the lower of cost or fair value. We have identified several properties that qualify due to either obsolescence or earthquake damage. The loss reported in 1997 for these impaired assets is $57 million which has been included in other operating expense in the 1997 Statement of Operations. No material impairments were recorded in 1998.

11. Contingent Liabilities

Each quarter we review litigation pending against us. As a result of this review, we classify and adjust our contingencies for claims which we think it is probable that we will lose and for which we can reasonably estimate the amount of the unfavorable outcome. These claims cover labor, equal employment opportunity, environmental issues, traffic accidents, injuries on postal properties, personal claims and property damages, and suits and claims arising from postal contracts. We also recognize the settlement of claims and lawsuits and revisions of other estimates.

As a part of our continuing evaluation of estimates required in the preparation of our financial statements, we recorded approximately $21 million decrease in liabilities in 1998, $26 million decrease in liabilities in 1997 and increased liabilities by approximately $120 million in 1996. We recognized settlement of claims and lawsuits and revised other estimates in our changes in contingent liabilities. Management and General Counsel believe that we have made adequate provision for the amounts which may become due under the suits, claims and proceedings we have discussed here.

12. Year 2000 Disclosure (Unaudited)

Consequences of failure to resolve the Year 2000 problem may range from minor effects on administrative or financial systems to having some impact on the ability of the Postal Service to sort and deliver mail. As part of our overall plan to address the Year 2000 Issue, we have completed assessments of our computer applications and mail processing systems to identify risk areas where these systems may have errors or failures beyond year 1999. Our assessments identified systems that required remediation, especially those that are critical to the operation of the Postal Service. So far, we have spent $94 million in upgrading our systems and preparing for Year 2000 readiness, and the total cost is expected to approach $500-600 million.

As of September 15, 1998, remediation efforts prior to testing had been completed on approximately 69 percent of all critical systems, including 93 percent of financial systems. We expect to complete the remaining remediation work, testing and implementation by the end of June 1999. Testing at a major mail processing plant and a bulk mail center revealed that the mail processing equipment can correctly process letters, flats and parcels to and through the Year 2000. To further prepare for the Year 2000 transition, we are developing contingency plans to address business continuity of our most critical systems and business processes, failures in the readiness of key suppliers and other third parties in order to minimize the impact on the Postal Service and our ability to deliver the mail.

In order to add value to our expedited delivery services, we will soon be able to confirm that delivery has been made.

Audit Committee Chairman's Letter

The members of the Audit Committee are selected by the Chairman of the Board of Governors. During 1998, the Committee, consisting of myself, Governors Ballard and McWherter, met seven times in conjunction with the regularly scheduled monthly Board meetings.

The Audit Committee is responsible, on behalf of the Board of Governors, for reviewing the financial reporting process, ensuring the soundness of the accounting and control practices, and the integrity of the financial statements of the Postal Service. As a part of that responsibility, the Committee also reviews other related issues as appropriate.

The Committee also recommends to the Board of Governors, subject to its approval, the selection of the independent public accounting firm responsible for the external audit work and oversees compliance with the terms of the contract.

During 1998, the Committee recommended and the Board approved changes to the Board's Audit Charter which were necessary to recognize the shift in audit responsibilities from the Inspection Service to the Office of the Inspector General.

The Committee discussed the overall scope of the work and the specific audit plans with the external auditors, Ernst & Young LLP, the Office of the Inspector General and the Postal Inspection Service at the start of the audit process. We also met regularly with management, the Inspector General, the Inspection Service, Ernst & Young, and the General Counsel jointly and, as appropriate, independently to discuss the progress of the audit work. This included an evaluation of the organization's internal controls and the quality of the financial reporting process. This also provided the opportunity for the Committee to assess the coordination of the audit work and ensure the independence and objectivity of the internal and external audit programs.

Accordingly, the Committee recommended and the full Board approved the financial statements for 1998.

Einar V. Dyhrkopp
Chairman, Audit Committee
December 8, 1998

Report of Independent Auditors

Board of Governors
United States Postal Service

We have audited the accompanying balance sheets of the United States Postal Service as of September 30, 1998 and 1997, and the related statements of operations, changes in net capital deficiency and cash flows for each of the three years in the period ended September 30, 1998. These financial statements are the responsibility of the United States Postal Service's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with generally accepted auditing standards and the standards for financial audits contained in *Government Auditing Standards* issued by the Comptroller General of the United States. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of the United States Postal Service at September 30, 1998 and 1997, and the results of its operations and its cash flows for each of the three years in the period ended September 30, 1998, in conformity with generally accepted accounting principles.

In accordance with *Government Auditing Standards,* we have also issued a report dated November 10, 1998, on our consideration of the United States Postal Service's internal control over financial reporting and on tests of its compliance with certain provisions of laws, regulations, contracts, and grants.

Ernst + Young LLP

Washington, D.C.
November 10, 1998

Financial History Summary

	1998	1997	1996*	1995*	1994*
Statements of Operations					
(dollars in billions)					
Total revenue	$ 60.1	$ 58.3	$ 56.6	$ 54.5	$ 49.6
Total expense	59.5	57.0	55.0	52.7	50.5
Net income (loss)	$ 0.6	$ 1.3	$ 1.6	$ 1.8	$ (0.9)
(dollars in millions)					
Operating revenue	$60,005	$58,133	$56,309	$54,176	$49,252
Revenue forgone appropriation	67	83	93	117	131
Total operating revenue	60,072	58,216	56,402	54,293	49,383
Compensation and benefits	45,588	43,835	42,676	41,931	39,609
Restructuring costs	-	-	-	-	-
Other expenses	12,190	11,038	10,437	8,799	8,846
Total operating expenses	57,778	54,873	53,113	50,730	48,455
Income from operations	2,294	3,343	3,289	3,563	928
Interest and investment income	44	115	142	216	193
Interest expense on deferred retirement liabilities	(1,597)	(1,597)	(1,449)	(1,364)	(1,336)
Imputed interest on retroactive assessment for employee benefits	(16)	(32)	(47)	(79)	(97)
POD Workers' Compensation expense	(8)	(258)	-	-	-
Interest expense on borrowings	(167)	(307)	(368)	(566)	(601)
Income (loss) before retroactive assessments and extraordinary items	550	1,264	1,567	1,770	(913)
Retroactive assessments for employee benefits**	-	-	-	-	-
Income (loss) before extraordinary item	550	1,264	1,567	1,770	(913)
Extraordinary item—debt refinancing premium	-	-	-	-	-
Net income (loss)	$ 550	$ 1,264	$ 1,567	$ 1,770	($913)
Balance Sheets					
ASSETS					
Current assets	$ 1,528	$ 1,463	$ 1,447	$ 2,775	$ 2,683
Property and equipment, deferred retirement costs and other assets	53,015	51,675	50,157	46,146	43,733
Total assets	$54,543	$53,138	$51,604	$48,921	$46,416
LIABILITIES					
Current liabilities	$14,913	$13,834	$12,573	$11,299	$11,665
Other liabilities	37,652	37,439	37,746	34,794	32,985
Long-term debt	2,788	3,225	3,909	7,019	7,727
(Net capital deficiency)/equity	(810)	(1,360)	(2,624)	(4,191)	(5,961)
Total liabilities and (net capital deficiency)/equity	$54,543	$53,138	$51,604	$48,921	$46,416
Changes in (Net Capital Deficiency)/Equity					
Beginning balances					
Capital contributions of the U.S. Government	$ 3,034	$ 3,034	$ 3,034	$ 3,034	$ 3,034
Deficit since Reorganization	(4,394)	(5,658)	(7,225)	(8,995)	(8,082)
Total beginning balance (net capital) deficiency)/equity	(1,360)	(2,624)	(4,191)	(5,961)	(5,048)
Net income (loss)	550	1,264	1,567	1,770	(913)
Ending balance***	$ (810)	$ (1,360)	$ (2,624)	$ (4,191)	$ (5,961)

* Certain reclassifications have been made to previously reported amounts. ** Relates to OBRA 1990 and 1993. *** Some totals may not add exactly due to roundi

1993*	1992*	1991*	1990*	1989*	1988*	1987*
$ 48.0	$ 47.1	$ 44.2	$ 40.1	$ 38.9	$ 35.9	$ 32.5
49.8	47.6	45.7	41.0	38.8	36.5	32.7
$ (1.8)	$ (0.5)	$ (1.5)	$ (0.9)	$ 0.1	$ (0.6)	$ (0.2)
$47,418	$46,151	$43,323	$39,202	$37,979	$35,036	$31,528
164	545	562	453	436	517	650
47,582	46,696	43,885	39,655	38,415	35,553	32,178
38,448	37,122	34,904	33,158	31,349	29,558	26,325
129	1,010	-	-	-	-	-
7,745	7,521	7,215	6,276	6,002	5,641	5,291
46,322	45,653	42,119	39,434	37,351	35,199	31,616
1,260	1,043	1,766	221	1,064	354	562
404	409	318	419	505	386	327
(1,346)	(1,269)	(1,172)	(1,056)	(1,020)	(921)	(904)
(70)	(81)	(91)	-	-	-	-
-	-	-	-	-	-	-
(620)	(638)	(480)	(458)	(488)	(416)	(208)
(372)	(536)	341	(874)	61	(597)	(223)
(857)	-	(1,810)	-	-	-	
(1,229)	(536)	(1,469)	(874)	61	(597)	(223)
(536)	-	-	-	-	-	-
$ (1,765)	$ (536)	$ (1,469)	$ (874)	$ 61	$ (597)	$ (223)
$ 4,478	$ 6,027	$ 4,863	$ 4,528	$ 5,448	$ 4,732	$ 5,341
42,803	41,638	38,403	32,977	31,324	29,940	26,746
$47,281	$47,665	$43,266	$37,505	$36,772	$34,672	$32,087
$10,140	$ 9,484	$ 7,400	$ 6,290	$ 5,898	$ 5,499	$ 5,603
33,503	32,291	30,474	25,825	25,103	24,020	21,911
8,686	9,173	8,139	6,668	6,173	5,613	4,435
(5,048)	(3,283)	(2,747)	(1,278)	(402)	(460)	138
$47,281	$47,665	$43,266	$37,505	$36,772	$34,672	$32,087
$ 3,035	$ 3,034	$ 3,034	$ 3,036	$ 3,039	$ 3,040	$ 3,041
(6,318)	(5,781)	(4,312)	(3,438)	(3,499)	(2,902)	(2,679)
(3,283)	(2,747)	(1,278)	(402)	(460)	138	362
(1,765)	(536)	(1,469)	(874)	61	(597)	(223)
$ (5,048)	$ (3,283)	$ (2,747)	$ (1,278)	$ (402)	$ (460)	$ 138

Operating Statistics

(in millions of units indicated)

Mail Revenue	1998	1997*	1996*	1995	1994*
First-Class Mail					
Pieces, number	101,172.8	99,659.9	98,216.1	96,295.9	95,332.9
Weight, pounds	4,180.2	4,115.1	4,019.5	3,865.0	3,780.9
Revenue	$33,982.7	$33,397.6	$33,116.5	$31,955.1	$29,376.8
Priority Mail					
Pieces, number	1,163.8	1,068.2	937.3	869.0	769.6
Weight, pounds	1,962.2	1,860.6	1,562.8	1,483.7	1,332.7
Revenue	$ 4,149.6	$ 3,856.9	$ 3,321.5	$ 3,074.7	$ 2,653.4
Express Mail					
Pieces, number	66.2	63.6	57.6	56.7	56.2
Weight, pounds	77.7	76.3	63.7	62.5	64.8
Revenue	$ 854.5	$ 824.7	$ 736.8	$ 710.9	$ 671.4
Mailgram					
Pieces, number	4.3	5.3	4.2	4.5	5.3
Revenue	$ 1.7	$ 2.0	$ 1.6	$ 1.5	$ 1.7
Periodicals					
Pieces, number	10,316.6	10,411.4	10,126.2	10,194.2	10,227.6
Weight, pounds	4,451.1	4,338.3	4,132.0	4,210.8	4,088.2
Revenue	$ 2,072.2	$ 2,067.5	$ 2,013.9	$ 1,971.9	$ 1,757.5
Standard Mail (A)					
Pieces, number	82,874.7	77,253.6	71,686.1	71,112.1	69,415.5
Weight, pounds	10,396.5	9,693.9	9,014.4	9,233.9	8,798.4
Revenue	$13,753.2	$12,876.0	$12,175.1	$11,791.5	$10,513.8
Standard Mail (B)					
Pieces, number	971.4	988.4	948.9	936.2	871.5
Weight, pounds	2,890.1	2,889.9	2,696.6	2,708.6	2,621.1
Revenue	$ 1,626.0	$ 1,627.6	$ 1,524.1	$ 1,524.7	$ 1,352.7
International Surface					
Pieces, number	95.6	97.4	104.5	105.5	122.5
Weight, pounds	95.6	102.0	106.5	114.2	117.0
Revenue	$ 183.7	$ 192.0	$ 198.9	$ 205.3	$ 204.5
International Air					
Pieces, number	848.3	909.5	948.6	695.6	739.7
Weight, pounds	148.9	157.2	147.0	135.2	122.9
Revenue**	$ 1,415.8	$ 1,422.8	$ 1,449.9	$ 1,254.1	$ 1,207.6
U.S. Postal Service					
Pieces, number	376.7	377.3	360.1	412.3	448.9
Weight, pounds	95.5	88.4	97.8	79.7	72.3
Free for the Blind					
Pieces, number	52.7	53.3	50.0	51.7	49.7
Weight, pounds	26.9	30.6	32.6	32.1	28.2
TOTALS***					
Pieces, number	197,943.2	190,888.1	183,439.5	180,733.7	178,039.4
Weight, pounds	24,324.7	23,352.4	21,873.0	21,925.7	21,026.5
Revenue	$58,039.4	$56,267.0	$54,538.2	$52,489.7	$47,739.4

* Certain reclassifications have been made to previously reported amounts.
** Includes foreign postal transaction revenue.
*** Agency and franked mail are included in their classes of mail.
Some totals may not add exactly due to rounding.

(in millions of units indicated)

Mail Revenue	1998	1997*	1996*	1995	1994*
Registry**					
Number of articles	15.3	16.3	18.6	20.5	22.6
Revenue	$ 89.2	$ 95.2	$ 113.3	$ 117.5	$ 120.3
Certified**					
Number of articles	275.8	284.5	270.8	288.8	240.2
Revenue	$ 382.2	$ 342.8	$ 558.5	$ 560.3	$ 428.4
Insurance**					
Number of articles	40.4	33.7	28.7	28.9	32.2
Revenue	$ 71.9	$ 61.0	$ 49.2	$ 51.8	$ 53.4
Return Receipts**					
Number of articles	235.1	260.5	-	-	-
Revenue	$ 259.7	$ 289.4	-	-	-
Collect on Delivery					
Number of articles	3.8	4.7	4.9	5.3	5.5
Revenue	$ 17.8	$ 21.8	$ 21.3	$ 20.8	$ 16.7
Special Delivery					
Number of articles	-	0.1	0.4	0.3	0.6
Revenue	$ -	$ 1.4	$ 3.8	$ 2.9	$ 5.0
Money Orders					
Number issued	208.6	206.1	214.0	201.8	196.7
Revenue	$ 210.1	$ 212.2	$ 221.3	$ 196.0	$ 178.0
Face value of issues (non-add)	$26,724.6	$26,180.4	$25,355.6	$24,608.5	$23,719.2
Other					
Box rent revenue	$ 617.4	$ 577.6	$ 570.3	$ 531.8	$ 489.2
Stamped envelope revenue	$ 17.4	$ 17.1	$ 15.9	$ 25.4	$ 17.2
Other revenue, net	$ 299.8	$ 247.0	$ 217.2	$ 180.0	$ 204.4
TOTALS					
Special Services revenue	$ 1,965.6	$ 1,865.6	$ 1,770.8	$ 1,686.5	$ 1,512.6
Mail revenue	$58,039.4	$56,267.0	$54,538.2	$52,489.7	$47,739.4
Operating revenue before appropriations	$60,005.0	$58,132.6	$56,309.0	$54,176.2	$49,252.0

* Certain reclassifications have been made to previously reported amounts.
** Return receipts have been broken out from registered, certified, and insurance special service categories.

	1998	1997	1996	1995	1994
Headquarters and Related Employees*					
Headquarters	2,231	1,949	1,951	1,825	1,701
Headquarters— Field Support Units	4,307	4,319	4,023	4,186	4,202
Inspection Service (field)	4,280	4,347	4,432	4,298	4,308
Inspector General	223	101	-	-	-
Subtotal	11,041	10,716	10,406	10,309	10,211
Field Career Employees*					
Area Offices	1,703	1,566	1,541	1,235	1,262
Postmasters/Installation Heads	26,156	26,256	26,489	26,564	26,803
Supervisors/Managers	36,508	35,708	35,282	34,732	34,616
Prof. Admin. Tech. Personnel	11,703	11,369	11,035	10,987	10,924
Clerks	293,829	280,818	276,964	273,526	265,294
Nurses	189	193	188	188	181
Mail Handlers	62,247	59,147	58,305	57,352	54,859
City Delivery Carriers	240,813	234,033	238,370	239,877	229,138
Motor Vehicles Operators	9,026	8,625	8,429	8,029	7,577
Rural Delivery Carriers— Full Time	52,241	49,957	48,340	46,113	45,049
Special Delivery Messengers	7	1,331	1,463	1,517	1,574
Bldg. & Equip. Maintenance Personnel	41,054	39,954	39,272	38,161	36,767
Vehicle Maintenance Personnel	5,524	5,501	4,882	4,794	4,689
Subtotal	781,000	754,458	750,560	743,075	718,733
Total Career Employees	792,041	765,174	760,966	753,384	728,944
Non-Career Employees*					
Casuals	25,711	32,615	24,696	26,401	25,674
Non-Bargaining Temporary	784	774	654	596	613
Rural Subs/RCA/RCR/AUX	56,265	54,834	53,768	50,269	46,589
PM Relief/Leave Replacements	12,613	12,687	12,724	12,774	12,683
Transitional Employees	17,222	26,789	33,066	31,548	37,542
Offices, Stations, and Branches					
Number of post offices	27,952	28,060	28,189	28,392	28,657
Number of stations and branches:					
Classified stations and branches	5,661	5,446	5,521	5,651	5,682
Contract stations and branches	2,974	2,907	2,897	3,480	3,424
Community post offices	1,572	1,606	1,605	1,626	1,609
Subtotal	10,207	9,959	10,023	10,757	10,715
TOTAL OFFICES, STATIONS, AND BRANCHES	38,159	38,019	38,212	39,149	39,372

* Complement data conforms with current method of counting career on-rolls employees using On-Rolls and Paid Employees Statistics database.

The Officers and the Inspector General

William J. Henderson
Postmaster General, Chief Executive Officer

Michael S. Coughlin
Deputy Postmaster General

Clarence E. Lewis, Jr.
Chief Operating Officer
and Executive Vice President

Allen R. Kane
Chief Marketing Officer and Senior Vice President

M. Richard Porras
Chief Financial Officer and Senior Vice President

Mary S. Elcano
Senior Vice President and General Counsel

Norman E. Lorentz
Senior Vice President and Chief Technology Officer

John E. Potter
Senior Vice President, Labor Relations

Deborah K. Willhite
Senior Vice President, Government Relations

Senior Vice President, Operations (vacant)

Nicholas F. Barranca
Vice President, Operations Planning

Anita J. Bizzotto
Vice President, Marketing Systems (as of 6/99)

Sylvester Black
Vice President, Network Operations Management

Frank P. Brennan, Jr.
Vice President, Corporate Relations

William J. Brown
Vice President, Field Retail Operations

James A. Cohen
Judicial Officer

Robert T. Davis
Vice President, Area Operations (Southeast)

Patrick R. Donahoe
Vice President, Area Operations (Allegheny)

William J. Dowling
Vice President, Engineering

Jesse Durazo
Vice President, Area Operations (Pacific)

Patricia M. Gibert
Vice President, Retail

James F. Grubiak
Vice President, International Business

Kenneth J. Hunter
Chief Postal Inspector

John F. Kelly
Vice President, Expedited/Package Services

Charles K. Kernan
Vice President, Area Operations (Southwest)

Robert Krause
Vice President, Core Business Marketing

Yvonne D. Maguire
Vice President, Human Resources

William H. McComb
Vice President, Area Operations (Midwest)

Suzanne Medvidovich
Vice President, Diversity Development

Henry A. Pankey
Vice President, Area Operations (Mid-Atlantic)

Don W. Peterson
Vice President, Quality

Darrah Porter
Vice President, Strategic Initiatives

John A. Rapp
Vice President, Field Operations Support

Robert A. F. Reisner
Vice President, Strategic Planning

Michael J. Shinay
Vice President and Consumer Advocate

David Solomon
Vice President, Area Operations (New York Metro)

Gail G. Sonnenberg
Vice President, Tactical Marketing
and Sales Development

Jon Steele
Vice President, Area Operations (Northeast)

A. Keith Strange
Vice President, Purchasing and Materials

Rudolph K. Umscheid
Vice President, Facilities

Craig G. Wade
Vice President, Area Operations (Western)

John H. Ward
Vice President, Finance, Controller

John R. Wargo
Vice President, Customer Relations

J.T. Weeker
Vice President, Area Operations (Great Lakes)

Richard D. Weirich
Vice President, Information Systems

Karla W. Corcoran
Inspector General

Glossary

Accruals: Revenue and expenses that are recorded as they occur, even though they may not have actually been paid.

Amortize: To reduce the value of an asset through regular charges to income over time; or to write off expenditures by prorating them over a period of time.

Appropriation: Public funds set aside by Congress for a specific purpose.

Barcode: A series of vertical full bars and half bars representing the ZIP Code information printed on a mailpiece to facilitate automated processing by barcode reader equipment.

Board of Governors: As the governing body of the Postal Service, the Board is comparable to a board of directors of a private corporation. The Board includes nine governors who are appointed by the president with the advice and consent of the Senate. The nine governors select a Postmaster General, who becomes a member of the Board, and those 10 select a Deputy Postmaster General, who also serves on the Board. The Board directs and controls the expenditures and reviews the practices and policies of the Postal Service.

Callable: Debt that the Postal Service as the borrower has the right to repurchase.

Capitalize: To treat an expenditure as an asset; or to compute the present value of a future payment that will be paid over a period of time.

Classification Reform: On July 1, 1996, the Postal Service adjusted the domestic mail classification system to establish a simple, more consistent rate structure and to keep its products in line with the changing needs of the marketplace.

Contribution: The difference between the revenue from a class of mail and that class's volume-variable costs. For example, if a class of mail has revenues of $1.5 billion and volume-variable costs of $1 billion, its contribution is $500 million, which means that this class of mail covers its costs and contributes $500 million to the common costs of all mail services.

Corporate Call Management: National service centers accessible through a toll-free number that provide callers with postal information and services.

CustomerPerfect!: A quality process management system that builds customer satisfaction and excellence into every process and procedure of the Postal Service.

Delivery Confirmation: Delivery confirmation is a special service designed to provide the date of delivery or attempted delivery for Priority Mail and Standard Mail (B)—parcels, bound printed matter, and library mail.

Depreciate: To periodically reduce the estimated value of an asset over the course of its useful life.

Deputy Postmaster General (DPMG): A member of the Board of Governors, jointly appointed by the Postmaster General and Governors.

Economic Value Added (EVA): A measure of financial performance calculated by taking net operating income and subtracting a charge for the capital used to produce that income (EVA = net operating income – capital charge).

Equity: The difference between the value of all assets less all liabilities.

Express Mail: The Postal Service's premium delivery service, providing guaranteed overnight delivery for documents and packages weighing up to 70 pounds. Both domestic and international services are offered.

First-Class Mail: A class of mail including letters, postcards, and postal cards, all matter wholly or partially in writing or typewriting, and all matter sealed or otherwise closed against inspection.

Fixed Asset: Any tangible property such as buildings, machinery and equipment, furniture, and leasehold improvements.

Generally Accepted Accounting Principles (GAAP): The rules and procedures of accepted accounting practice as defined by the Financial Accounting Standards Board.

Global Package Link (GPL): International package delivery service and state-of-the-art information system for volume mailers sending merchandise to participating overseas markets.

Global Priority Mail (GPM): A category of international mail that provides fast service at attractive rates to 27 countries.

Gross Domestic Product (GDP): The total market value of all the goods and services produced in one year in the United States.

Household Diary Study: A multiyear market research study of all the mail that originates and arrives in a scientifically selected number of households. For one week, all the members of a household record every piece of mail they send or receive, including such information as the class of mail, the identity of the senders and receivers, and the content.

International Business Unit (IBU): A strategic business unit of the Postal Service that focuses exclusively on the international market and is responsible for both household and commercial services. The IBU also is responsible for Army Post Office and Fleet Post Office services.

Leasehold: An asset that gives the Postal Service the right to use property under a lease.

Liability: Any debt or obligation the Postal Service is bound to pay.

Negative Equity: The amount of money that the Postal Service does not have to settle all of its obligations if they were to come due immediately.

Optical Character Reader (OCR): An automated mail processing machine that optically scans letter mail, locates the address, and translates the address information into a barcode representation of the ZIP+4 delivery point barcode.

Periodicals: A class of mail, formerly called second-class mail, that consists of magazines, newspapers, and other publications.

Point-of-Service ONE (POS ONE): An electronic retail sales device that assists employees with retail transactions and provides product inventory and sales information.

Postal Inspection Service: The investigative arm of the Postal Service responsible for internal audits and investigating criminal acts involving the mails and misuse of the postal system.

Postal Rate Commission (PRC): An independent federal agency that makes recommendations concerning Postal Service requests for changes in postal rates and mail classifications.

Postal Stores: A modernized Postal Service retail unit that has postal products on open display, offering customers self-service selection and full-service counter assistance.

Postmaster General (PMG): The chief executive officer of the Postal Service, appointed by and serving at the pleasure of the Governors.

Present Value: The value today of a future payment that is discounted at a stated rate of compound interest. For example, the present value of $100 that will be paid to the Postal Service 10 years from now is about $38.55, if we discount that $100 at a rate equal to 10 percent interest compounded annually.

Priority Mail: Priority Mail provides two- to three-day delivery service.

Processing and Distribution Center (P&DC): A large mail-sorting and dispatching plant that serves as a hub for mail originating from post offices, collection boxes and customer mailboxes, and large-volume mailers in a designated service area.

Process Management: A systematic, data-based approach to improving the performance of business. It is an approach that identifies opportunities for improvement using proven problem-solving methods.

Receivable: Money that is owed to the Postal Service.

Recognize: To record in Postal Service accounts as income or expense.

Rural Free Delivery (RFD): Begun in 1896 as an experiment in West Virginia, RFD brought daily mail delivery to farmers and others living outside urban areas.

Standard Mail: New name for the merger of third-class mail and fourth-class mail as one class under Classification Reform implementation of July 1, 1996.

United States Mail: Any mailable matter that is accepted for mail processing and delivery by the Postal Service.

United States Postal Service (USPS): The successor to the Post Office Department, the USPS was established by the Postal Reorganization Act of July 1, 1971, as an independent, self-supporting federal agency within the executive branch.

Universal Service: The Postal Service's mandate and commitment to the nation to provide mail delivery service at uniform and reasonable rates to everyone, everywhere, six days a week.

Year: As used in the financial section of this report, it means the Postal Service fiscal year, which is the 12-month period during which the Postal Service keeps accounts, beginning Oct. 1 and closing Sept. 30.

Zoning Improvement Plan (ZIP): Established in 1963, a system of five-digit codes or ZIP codes that identifies the individual post office or metropolitan area delivery station associated with every mailing address. This system was later expanded to ZIP+4, which includes more defined delivery areas.

How to Read our Annual Report and Financial Statements

Do you have four minutes? That's all the time you need to take a quick tour through our annual report and learn a lot about the Postal Service. We think that you'll not only have fun browsing through our report because of our pictures, illustrations and factoids, but you'll also see just how important our message is.

After enjoying the pictures and illustrations, be sure to read Bill Henderson's letter. As our CEO he sets the strategy for the future. His letter will help you understand the challenges we face and the strategy he has put in place to fulfill our mandate to bind the nation together now and in the future. Next, take a quick look at either the Financial Highlights (page 2) or the Financial History (page 72). These pages will give you an idea of where we've been and suggest where we're headed.

Now, if you want to learn more, follow the guide below and examine our financial statements. Don't worry, you don't have to be a financial whiz. It's as easy as one, two, three.

STATEMENT OF OPERATIONS

Operating revenue: Increased for the fourth straight year.

Interest and investment income: For the fourth straight year we've reduced our income in this category because we manage our cash more effectively and invest in property and equipment so we can reduce costs, increase efficiency, and improve service.

Interest expense on borrowings: We reduced this expense 55 percent over the last three years by using the cash we generate from our operations instead of borrowing to make the investments we need to make.

Total expenses: Held to increases of less than 5 percent for the past four years.

Net income: For the fourth straight year we had positive net income.

BALANCE SHEETS

Cash and cash equivalents: We think it's better to work an asset than park it in a bank.

Workers' compensation costs: Any change in this liability directly reduces our bottom line, and this year we had an increase of 4 percent.

Total net capital deficiency: An improvement of 40 percent from 1997 and an improvement of 69 percent since 1996.

Total property and equipment: We increased our investments in property and equipment by 7.3 percent over 1997.

Deferred retirement costs: This asset and the offsetting amounts payable for deferred retirement benefits are best explained in Note 2 to the Financial Statements.

STATEMENTS OF CHANGES IN NET CAPITAL DEFICIENCY

Capital Contributions of U.S. Government: The federal government has invested $3.034 billion in the Postal System.

Accumulated Losses Since Reorganization: Since 1994, we've reduced our cumulative losses from $8.995 billion to $3.844 billion.

Total Net Capital Deficiency: Since 1994, we've reduced our negative equity to $810 million.

STATEMENTS OF CASH FLOWS

Increase (decrease) in workers' compensation costs: This increase of $195 million over 1997 comes directly from our bottom line.

Net cash provided by operating activities: For the last four years we've been generating the cash we need to make investments for the future. That means we don't have to borrow as much as we once did.

Purchase of property and equipment: Over the last four years we've been increasing our investments in property and equipment so we can serve our customers better and reduce costs.

If you want to learn more about us (and we hope you do), you should read our Management Discussion and Analysis and our Notes to Financial Statements, which are full of important information on our financial condition and our plans for the future. And to make it easy for you to read these sections, we've written them in plain English so you don't have to be a lawyer or accountant to understand them.

Finally, we suggest that you compare us to other companies. Since many companies publish their annual reports on the World Wide Web, you can find a number of reports to which you can compare ours. And to help you read these reports, you can find a guide to reading annual reports at www.ibm.com/FinancialGuide.

A tradition of delivering value

A mandate to deliver to everyone, everywhere, every day

- Serve both urban and rural areas with regularly scheduled daily collection and delivery to secure and protected mail boxes.
- Receive, transmit, and deliver written and printed materials and parcels throughout the United States and the world.
- Operate postal facilities that create access for all citizens; no post office can be closed solely because it operates at a deficit.
- No unreasonable discrimination or preferences among users of the mails.
- A stamped letter will carry a message anywhere in the United States at a uniform rate.

—Title 39, United States Code

1999 Stamps

the NATURE of AMERICA

This preview of the 1999 stamps is a tentative schedule, subject to changes in the issue dates, formats, and design elements.

Not pictured— The Postal Service's Celebrate The Century program continues in 1999 with the issuance of stamps commemorating the 1940s, 1950s, 1960s, and 1970s.

Holiday Contemporary Greetings (Deer)
October
Rudolph, WI 54475

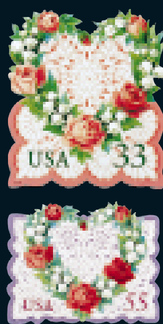
Washington and Lee University
February
Lexington, VA 24450

University of Wisconsin–Madison
February
Madison, WI 53714

Mount Vernon
TBD
Alexandria, VA 22303

Redwood Library and Athenaeum
March
Newport, RI 02840

Holiday Traditional Vivarini: Madonna and Child
October
Washington, DC 20066



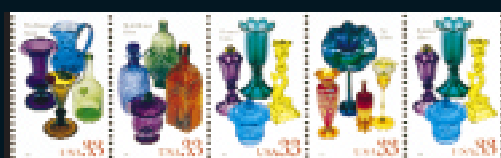
Victorian Love
January
Loveland, CO 80538

All Aboard! 20th Century Trains
August
Cleveland, OH 44101

Aquarium Fish
June
Anaheim, CA 92803

Lunar New Year: Year of the Hare
January
Los Angeles, CA 90001

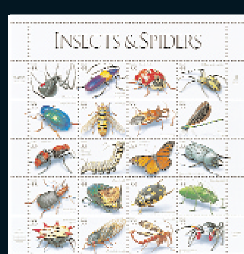
Broadway Songwriters
September
New York, NY 10199



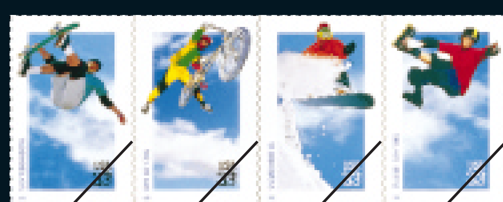
American Glass
June
Corning, NY 14830

Arctic Animals
March
Barrow, AK 99723

Hollywood Composers
September
Los Angeles, CA 90001

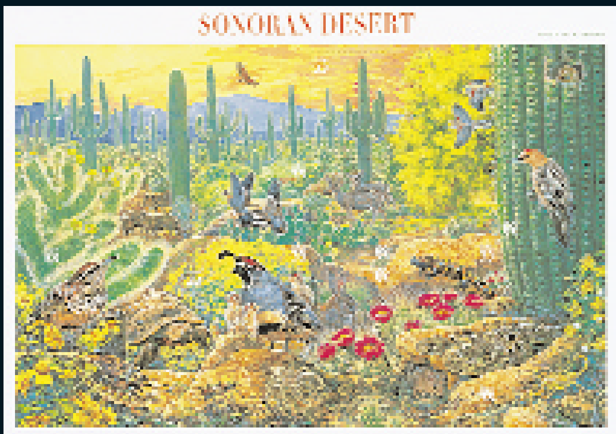


Insects and Spiders
October
TBD



Xtreme Sports
June
San Francisco, CA 94188

Nature of America
Sonoran Desert
March
Tucson, AZ 85726



Tropical Flowers
June
Hawaii

John and
William Bartram
May
Philadelphia, PA 19104

Hospice Care
February
Largo, FL 33740

Prostate Cancer
Awareness

Daffy Duck
April
Los Angeles, CA 90001

James Cagney
July
TBD

Ayn Rand
April
New York, NY 10199

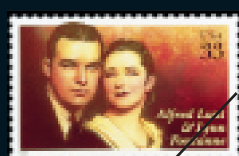
Malcolm X
January
New York, NY 10199

Honoring Those
Who Served
August
Kansas City, MO 64108

California Gold Rush
June
Sacramento, CA 95813

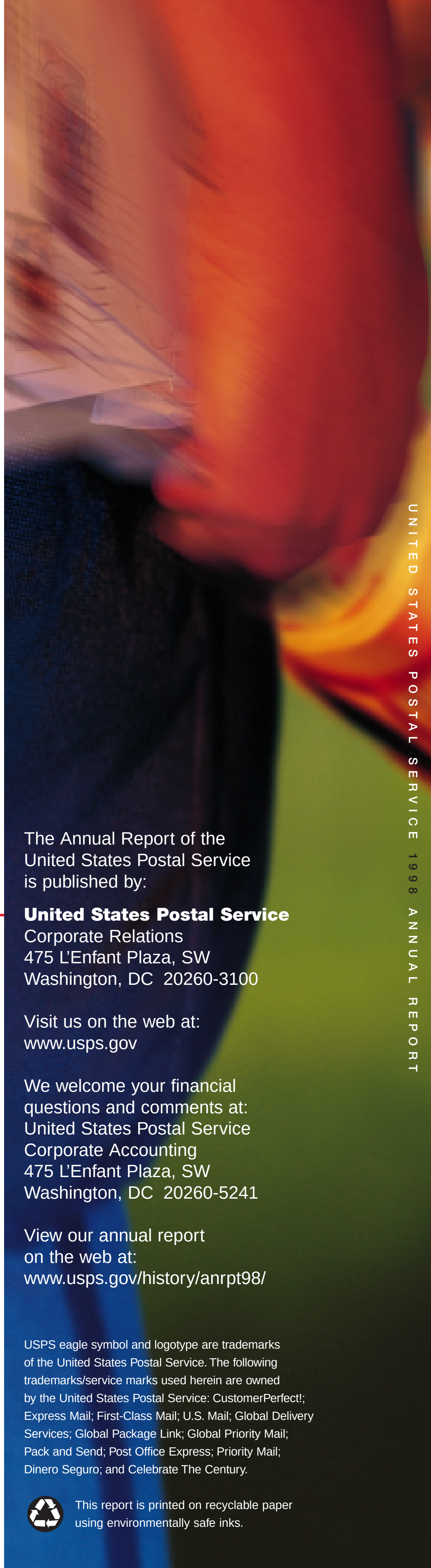
Irish Immigration
February
Boston, MA 02205

Frederick Law Olmsted
September
Boston, MA 02205



Alfred Lunt &
Lynn Fontanne
March
New York, NY 10199

NATO
April
Washington, DC 20066



UNITED STATES POSTAL SERVICE 1998 ANNUAL REPORT

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The Annual Report of the United States Postal Service is published by:

United States Postal Service
Corporate Relations
475 L'Enfant Plaza, SW
Washington, DC 20260-3100

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